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THREE STUDIES INVESTIGATING THE LEGAL LIABILITY IMPLICATIONS OF THE
SARBANES-OXLEY ACT OF 2002

by

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A dissertation submitted in partial fulfillment of the requirements
for the degree of Doctor of Philosophy
in the Kenneth G. Dixon School of Accounting
in the College of Business Administration
at the University of Central Florida
Orlando, Florida

Summer Term
2010

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ABSTRACT

This dissertation examines the litigation and legal liability exposure of auditors related to the Sarbanes-Oxley Act of 2002 (SOX). Three separate studies were conducted to examine how auditor's litigation exposure is evaluated by potential litigants (lawyers), and how auditor liability is evaluated by jurors, following the bankruptcy of a client. The first study examines whether the auditor's SOX Section 404 reporting decisions influence lawyers' assessments of their litigation exposure. The second study investigates whether voluntary disclosures of significant deficiencies in internal controls within the SOX Section 404 report, and the subjectivity of the internal control judgments made by the auditor, influence jurors' perceptions of auditor liability for negligence. The third study examines how the requirements of SOX Section 302 related to audit committee independence and audit committee expertise influence jurors' perceptions of auditor independence and auditor liability for negligence. Overall, these three studies provide insights on how different provisions of SOX, specifically the Section 404 report and audit committee requirements, influence the likelihood that auditors will be sued and the likelihood that they will be held liable by a jury.

ACKNOWLEDGMENTS

Completion of this dissertation would not have been possible without the immeasurable help and support from others, to whom I would like to express my gratitude. I would first like to thank my dissertation chair, Vicky Arnold. I truly appreciate the time and commitment Vicky dedicated to every stage of the dissertation process. Vicky has been a wonderful mentor for the last five years, and any success I have in my career moving forward will be greatly attributed to her guidance, dedication, and continued support in my development as a scholar.

I would also like to thank my dissertation committee members, Steve Sutton, Robin Roberts, and Stephen Sivo, for their helpful feedback, support, and guidance throughout the dissertation process. I am also thankful to the faculty and doctoral students who provided helpful suggestions, assisted me with recruiting participants for my studies, and contributed significantly to the development and pre-testing of the cases and questionnaires in this dissertation.

Specifically, I would like to thank my fellow doctoral students Amy Hageman, Anna Alon, Joe Canada, Clark Hampton, Erin Burrell, Jason Chen, Kemi Onwuchekwa, Robert Tennant, and Kimberly Zahller. Faculty members who were especially supportive are Donna Bobek Schmitt, Gregory Trompeter, Marcy Hampton, Nancy Klintworth, Tanya Benford, Sean Robb, Peggy Dwyer, Scott Smith, and Carolyn Massiah. I truly appreciate the hours devoted to helping me through this process, and am fortunate to consider all of you my colleagues.

I would also like to express many thanks to those who have been there for me since the beginning. I would not be where I am today without the support of many family members and friends who have always believed in me. Most importantly, I would like to thank my husband, Bobby, who has always provided me with unconditional love and support.

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INTRODUCTION AND OVERVIEW OF THREE STUDIES

The Sarbanes-Oxley Act of 2002 (SOX) has been hailed as one of “the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt” (Bumiller, 2002). The legislation was enacted primarily in response to a string of accounting failures in large corporations with the purpose of increasing the quality of the standards followed by public companies and their auditors (Canada et al., 2007). As SOX had a far reaching impact on the auditing and financial reporting process, a significant amount of research has been conducted to examine the successes, failures, costs, and benefits of this Act (Boyle and Webb, 2007). Some researchers conclude that SOX was a huge success for protecting the public interest (Canada et al., 2007), as others argue that the costs to comply with SOX may outweigh the benefits (DeFond and Francis, 2005; Solomon, 2005).

One of the major SOX-related costs is audit fees, which remain high because of the increased reporting responsibilities and resulting liability exposure for auditors (DeZoort et al., 2008). Although auditors have a long trend of campaigning for limitations in legal liability exposure (Roberts et al., 2003), the recent failure of a large, international audit firm renewed the debate over whether auditors should be protected from liability exposure (Sukhraj, 2008). In 2008, auditors and various members from practice asked the U.S. Treasury Department’s Advisory Committee on the Auditing Profession to recommend placing restrictions on auditor liability exposure. Supporters of this recent movement for auditor liability reform claim that auditors are currently faced with exposure to billions of dollars in damages related to pending lawsuits which often settle out of court because the risk of trial is too great (Sukhraj, 2008). Accordingly, audit firms asked the committee to recommend that Congress place limitations on

auditor liability to prevent another collapse of a large audit firm (Sukhraj, 2008). After reviewing the evidence presented, the U.S. Treasury Committee voted against making any outright recommendations for liability limitations, citing lack of consensus on the issue (Advisory Committee on the Auditing Profession, 2008). The treasury also encouraged the debate on auditor liability exposure to continue, opening the opportunity for future discussions at the policy-making level about the concerns and solutions expressed by members of the professional community.

This research examines different factors related to provisions of SOX that could potentially impact the litigation and legal liability exposure of auditors. Since auditors are not likely to be awarded increased protection from litigation in the near future, as indicated by the lack of consensus in the U.S. Treasury Committee (Advisory Committee on the Auditing Profession, 2008), an examination of the legal liability exposure of auditors in the current context of SOX is highly relevant. Research on this topic could provide auditors with insight into how their reporting decisions and client characteristics can influence both the likelihood that they will be sued and the outcome of potential litigation. Results of this research could also be used in future discussions of auditor liability exposure to argue for or against future legislation to repeal or change SOX, or to provide a safe harbor specifically related to internal control reporting. The research will also add to the growing body of academic literature on SOX, which has been a highly published topic area in recent journals. Although many studies have been conducted in the past to examine legal liability, how SOX provisions may affect auditor legal liability is relatively unknown. The findings of this research adds to the body of literature by answering pivotal questions about auditor liability exposure as the profession moves forward into a new era of regulation.

Three studies were conducted to address how specific SOX provisions may influence auditor litigation risk and liability exposure. Controlled experiments were conducted in each study to understand how certain SOX-related conditions can influence the decisions of both potential litigators, who decide whether the auditor should be sued, and jurors, who decide the fate of the auditor in a trial setting. In the next chapter of this document, a review of the literature is presented to provide a background on Sections 404, 301 and 407 of SOX. This review chapter also provides a discussion of the literature on the current legal environment for auditors. Then, study one examines how the auditor's internal control report influences the likelihood that potential litigators will recommend suing the auditor for negligence. Study two extends this line of research by assuming the auditor has been sued, and examines how the internal control report influences jurors' decisions on the auditor's liability for negligence. Finally, study three examines how the characteristics of the audit committee may influence how independent auditors are perceived, and ultimately influence whether jurors will find the auditor guilty. The following sections introduce each of these chapters in more detail to provide an overview of the motivations, research method, and contributions of each study.

Literature Review: The Sarbanes-Oxley Act of 2002 and Auditor Liability

The literature review chapter provides an overview of SOX. Specifically, the chapter reviews Sections 404, 301, and 407 and discusses the provisions of this legislation that may influence the legal liability landscape for auditors under securities and common law. Related research is reviewed and synthesized. Overall, the literature review chapter introduces the literature in this area to provide a framework and motivation for three studies investigating auditor liability exposure related to SOX.

Study One: SOX Section 404 and Auditor Litigation Exposure: an Investigation of Potential Litigators' Consideration of the Auditor's Report on Internal Controls

Study one examines whether Section 404 disclosures influence auditor litigation risk. Audit firms have argued that they are unnecessarily exposed to litigation risk from frivolous lawsuits, no matter how high quality their audits may be (Sukhraj, 2008). Some researchers argue the reputation losses that occur with audit firms being associated with lawsuits, regardless of outcome, can be detrimental to the firm (Chaney and Philipich, 2002; Krishnamurthy et al., 2006). This study investigates whether the disclosures within the audit opinion on internal controls can operate as a red flag that ultimately lessens the likelihood that potential litigators will recommend suing the auditor. Therefore, this study examines how SOX Section 404 disclosures may perhaps *prevent* auditor litigation by providing an opportunity for auditors to increase the quality of their disclosures and provide adequate signals to stakeholders about potential internal control issues.

A 3x1 between-subjects experiment was conducted with lawyers, manipulating the auditor's opinion on internal controls as unqualified, unqualified with description of significant deficiencies, or adverse with description of material weakness. Lawyers reviewed a scenario where the auditor issued an unqualified audit opinion on financial statements on a company that ended up declaring bankruptcy. They also viewed the auditor's opinion on internal controls (manipulated as described above). Then, when they finished reviewing the information provided, participants were asked to provide their opinion on whether they would recommend that the auditor be sued for negligence in this situation.

Results of this study indicate that the auditor's report on controls has the potential to decrease the litigation exposure of auditors, as auditors providing an adverse opinion on internal

controls were assessed most favorably by lawyers. However, voluntary disclosures of significant deficiencies in internal controls did not significantly influence auditor litigation exposure in this study, indicating that the stronger message provided by an adverse Section 404 opinion is necessary in order to decrease litigation exposure. Results suggest that auditors should consider the potential impact of the Section 404 report on litigation risk, which could potentially influence planning and reporting decisions during an audit.

Study Two: Auditor Liability for Section 404 Reports: An Investigation of Jurors' Consideration of Auditor Disclosure of Internal Control Deficiencies

Study two builds on the results from study one by examining whether additional disclosures within the auditor's report on internal controls can provide a solid defense to influence jurors' decisions in a trial setting. Study one emphasizes how auditors' reporting decisions can potentially prevent the auditor from being sued for negligence. In contrast, study two assumes that the auditor has already been sued for negligence, and focuses on how internal control reporting decisions and the nature of the internal control in question can influence trial outcomes. Although results of study one suggest that voluntary disclosures of internal control issues do not significantly influence the likelihood that auditors will be sued for negligence, this study proposes that auditors providing voluntary disclosures may benefit from a reduced liability risk in the event of a jury trial.

This study also provides insight into the potential for increased liability exposure when auditors fail to disclose specific types of material weaknesses, based on the auditability of the deficiency related to the audit failure. Auditability represents the ability for the auditor to perform procedures to test the control (Hammersley et al., 2008). For example, controls at the transaction level (i.e., signature approvals) are often classified as auditable because the

procedures auditors perform to evaluate these controls can involve a statistical sampling of the transactions that occurred during the period to test for compliance. In contrast, the less auditable controls (i.e., management integrity, tone at the top policies, etc.) often rely solely on subjective evidence, such as interviews, placing the responsibility more heavily on the auditor to decide whether the control is effective (Hammersley et al., 2008).

A 2x2 between-subjects experiment was conducted to examine the impact of the nature of the internal control weakness (more auditable/less auditable) and the contents of the auditor's report on internal controls (disclosure/no disclosure of significant deficiency) on the decisions of jury eligible individuals in a fictitious trial setting. Members from the community, recruited to represent jury eligible individuals, were presented with a written scenario of a trial where the auditor is being sued for negligence. Participants were then asked to provide their opinions, as a jury member, on whether the auditor should be found liable for negligence.

Results suggest that auditors are exposed to the least liability when they have provided a voluntary disclosure of a more auditable internal control issue within the Section 404 report. The insights from this study are important, as little is known about the impact of Section 404 reporting on jurors' perceptions of auditors in a trial setting. Since auditors currently are arguing for limitations on liability, but are not likely to achieve this goal in the immediate future (Sukhraj, 2008), the results of this study could provide auditors with information that could assist them with the decision of whether to risk a trial in certain situations. Results also suggest that different types of internal controls may expose auditors to more liability, which could be useful knowledge for auditors at the planning and reporting stages of the audit. Also, by providing evidence that communication within the Section 404 reports may protect auditors from liability

in a trial setting, the study could encourage auditors to increase the quality and transparency of their Section 404 reports by providing more detailed disclosures of internal control deficiencies.

Study Three: The Influence of Audit Committee Member Independence and Expertise on Jurors' Perceptions of Auditor Independence and Attributions of Liability

Study three examines how audit committee characteristics can influence jurors' perceptions of auditor independence and liability in a trial setting. This study specifically focuses on the characteristics of audit committee member independence and expertise. According to the provisions of SOX Section 407, public companies are required to disclose whether they have at least one expert member on the committee. SOX Section 301 also requires that all audit committee members meet minimum standards for independence (U.S. House of Representatives, 2002)¹. These provisions were intended to increase the quality of the financial reporting and audit processes by providing a setting where auditors operate under increased independence from management's influence (DeZoort et al., 2002). Past research on juror decision-making suggests that when auditors are perceived as less independent, they are more likely to be held liable for negligence (Brandon and Mueller, 2006). Therefore, this study examines how characteristics of a client's audit committee can influence how the auditor's reporting decisions are perceived by jurors.

A 2x2 between-subjects design was implemented to examine whether audit committee expertise (high/low) and audit committee independence (high/low) influence perceptions of auditor negligence in a case where auditors are being sued for negligence following a failure to identify fraud within a company. Members of the community, representing jury eligible

¹ See detailed discussion of these provisions in the section below titled SOX Sections 301 and 407: Provisions on Audit Committee Composition.

individuals, reviewed this case and answered questions related to their perceptions of audit committee independence, audit committee expertise, auditor independence and auditor liability for negligence. Responses were tested in a PLS model to determine the influence of jurors' perceptions of audit committee expertise and audit committee independence on auditor independence and auditor liability.

Results strongly suggest that perceptions of audit committee independence directly influence perceptions of auditor independence. In addition, perceptions of auditor independence significantly influenced jurors' assessments of auditor liability, such that auditors were exposed to more liability when they were perceived as less independent. Although audit committee expertise was not found to significantly influence perceptions of auditor independence, the interaction between audit committee expertise and audit committee independence was found to directly influence liability assessments. Specifically, auditors were exposed to the most liability when audit committee members were perceived to have higher levels of expertise and lower levels of independence.

The outcome of this study provides auditors with important insights about how the audit committee can influence auditor liability exposure. These insights could be used to assess litigation risk when deciding whether to accept a client. This increased understanding of potential jury outcomes could also be utilized by auditors and their legal council to determine trial strategy when auditors are sued for negligence. Results suggest that auditors should carefully assess the independence and expertise of the members of the audit committee, since each quality has the potential to influence their liability exposure.

Overall Contribution

Overall, the three studies outlined above provide insights that may assist auditors in the planning, evidence collection, and reporting stages of the audit, and inform legal counsel of specific risks associated with jury trials in the current legal liability setting following SOX implementation. The next chapter provides an overview of the literature on SOX and auditor liability. Then, three studies are presented which examine the impact of specific aspects of SOX from a legal liability perspective.

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LITERATURE REVIEW: THE SARBANES-OXLEY ACT OF 2002 AND AUDITOR LIABILITY

Introduction to SOX

SOX is often referred to as the most historic intervention in the regulation of accountants since the 1930's great depression era (DeFond and Francis, 2005). Following a trend of highly publicized accounting failures, Congress intervened by creating legislation to significantly increase the responsibilities of individuals involved with the financial reporting process for public companies and heightened the level of oversight with the audit process. The many provisions outlined within this act sparked an active debate among professionals, standard setters, and researchers, generating a wide body of research to examine the impact of SOX (see review of literature in Boyle and Webb, 2007). The feedback has been mixed, with some research proposing that SOX has had an overall positive effect on the quality of financial reporting (Boyle and Webb, 2007), and others citing increased costs and liability exposure as unwanted and unintended negative consequences (Pritchard, 2008). This research specifically examines two of the major research areas emerging as a result of SOX legislation: internal control reporting requirements under Section 404, and corporate governance requirements under Sections 301 and 407. The following sections discuss these requirements in detail, and overview the related research on Sections 404, 301, and 407.

SOX Section 404: Internal Control over Financial Reporting

One of the most highly criticized requirements of SOX was the significant increase in responsibility for managers and auditors to evaluate and provide a report on the effectiveness of internal controls (Brown, 2006; Bedard et al., 2007; Krishnan et al., 2008). Section 404 first

requires management to compile a report on internal controls that includes a discussion of any issues that could prevent the company from reporting financial statements free of material misstatement (Krishnan et al., 2008). Then, the auditors are required to conduct their own independent evaluation of internal controls as part of an integrated audit of financial statements, and issue a separate opinion on internal controls based on their findings. Although the auditor may choose to rely on some of the work conducted by management in their assessment of internal controls, much this evaluation is based on work conducted independently by the auditor so that they may develop their own assessment of internal controls. The auditor's opinion on internal controls is disclosed in the Auditor's report on internal controls (Section 404 report), which can be presented as a separate report or combined with the auditor's report on financial statements. In this report, auditors are required to report any control deficiencies that are deemed to be material weaknesses in internal controls that could result in material misstatement of the financial statements (PCAOB, 2007).

The requirements outlined by Section 404 created a public outcry for clarification on the correct way to interpret specific portions of the act, as auditors and managers both experienced significant delays in reporting in an unfamiliar regulatory environment (Ettredge et al., 2006; Parles et al., 2007). As a result, the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)² have issued standards and implementation guidance that outline specific steps that should be taken by management and auditors in completing their evaluation of internal controls and generating Section 404 reports (Barlas, 2007;

² Similar to the way the SEC oversees the financial reporting of public companies, the PCAOB was created by SOX to oversee the auditors of public companies in the U.S. All audit firms who audit public companies are required to register with the PCAOB and the organization conducts random reviews of a sample of the audits conducted each year. In addition, the PCAOB issues standards and implementation guidance for how public company audits are conducted (Coates, 2007).

Coates, 2007). This enhanced guidance outlined the process by which auditors should conduct their audit of internal controls and how deficiencies should be evaluated. The implementation guidance also provides specific details outlining how the results of the audit of internal controls should be reflected within the Section 404 report (PCAOB, 2007).

As one of the main requirements of Section 404, auditors are specifically required to integrate their audit of internal controls with their audit of the financial statements by conducting the audits simultaneously in order to reach conclusions based on outcomes of both audits (PCAOB, 2007). Completing these activities simultaneously allow the auditor to adjust their financial statement audit workload based on their internal control assessments. For example, if findings indicate that internal controls are strong in a certain area, then the auditor may decrease the amount of substantive testing for financial audit purposes. If internal control is deemed ineffective, auditors should adjust their procedures to test the impact of any deficiency on the financial statements. This may require additional compliance testing to gauge the pervasiveness of the control deficiency, and greater substantive testing at the account level to maintain an appropriate level of audit risk. Recent evidence suggests that this practice has been implemented by auditors, as indicated by a significant difference in audit fees, a common proxy for audit effort, associated with companies reporting material weaknesses in internal controls (Hogan and Wilkins, 2008).

Figure 1 provides a detailed outline of the decision process that auditors undergo with each internal control they evaluate during an audit. First, auditors must decide whether sufficient controls are in place and working properly. When the proper internal control is not in place, the auditor must document a control deficiency. A *control deficiency* occurs when “the design or operation of a control does not... prevent or detect misstatements on a timely basis” (PCAOB,

2007, p. 57). Once control deficiencies are identified the auditor must then assess the likelihood of the deficiencies to result in a material misstatement. If there is a reasonable possibility that the control will fail to allow management to detect or prevent misstatements, the auditor concludes that there is a significant deficiency in internal controls. If not, the issue remains solely a control deficiency. Significant deficiencies are considered to be “less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting” (PCAOB, 2007, p. 60). Once significant deficiencies are identified, the auditor must then evaluate how material the impact on financial statements would be if the control failed to detect or prevent misstatements. If the auditor concludes that the significant deficiency would not cause a material misstatement, then the auditor issues an unqualified opinion on internal controls and no disclosure is required for public companies but is required for non-public companies. If, on the other hand, the auditor concludes that the significant deficiency would result in a material misstatement, the auditor must issue an adverse opinion on internal controls and disclose the nature of the material weakness. A *material weakness* is identified when “there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis” (PCAOB, 2007, p. 85). Therefore, the main difference between significant deficiencies and material weaknesses is materiality.

The identification of control deficiencies, and the further classification as significant deficiencies or material weaknesses, has important implications for the Section 404 report. As shown in Figure 1, if the auditor only identifies control deficiencies or significant deficiencies they should issue an unqualified opinion on internal controls in the Section 404 report (PCAOB, 2007). Although the auditor is not specifically prevented from disclosing control deficiencies or

significant deficiencies in the Section 404 report, they are also not required to provide any related disclosures within this report referencing deficiencies they found during the audit. However, if one or more material weakness in internal controls is found during the audit, the auditor must issue an adverse opinion on internal controls (PCAOB, 2007). A Section 404 report with an adverse opinion on internal controls must provide a discussion of the controls that were deemed ineffective and disclose the potential impact on financial statements (PCAOB, 2007). Therefore, the assessment of materiality has important implications on what is disclosed within the Section 404 report.

This evaluation of materiality has been cited as a highly complex and inherently subjective component of the audit, as this task relies heavily on professional judgment (Tackett et al., 2006). One main difference between the audit of internal controls and the audit of financial statements is that the evaluation of a control deficiency does not focus on whether a misstatement has actually occurred, but whether the internal control is able to effectively prevent or detect a potential misstatement in the event of error or fraud (PCAOB, 2007). For evaluating internal controls, the focus for the auditor should be on risk factors that would indicate potential for errors or fraud to occur that could result in misstatement of the financial statements. The PCAOB specifically states, “The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made *without* quantifying the probability of occurrence as a specific percentage or range” (PCAOB, 2007, p. 419). This indicates that the auditor’s evaluation of internal controls may be qualitative in nature, which means less physical evidence is available to back-up the auditor’s judgment.

Auditing Standard No. 5 (AS5) additionally outlines specific factors that may signal to auditors that further investigation of the internal control is necessary. These factors may include

the following: management fraud, restatement activity, detection of material misstatements in current period, and ineffective oversight (PCAOB, 2007). The last example, ineffective oversight, is perhaps the indicator that relies most heavily on the auditor to make a qualitative judgment of materiality. In fact, research has often classified this particular internal control as less auditable, meaning that the auditor cannot necessarily provide direct evidence or documentation to support their judgment (Doyle et al., 2007). Therefore, one may argue that the evaluation of internal controls, at least in part, is inherently more complex and reliant on professional judgment than the financial statement audit task, in which the auditor often relies heavily on quantitative materiality ranges to reach conclusions.

Because of this uncertainty and heavy reliance on professional judgment, the evaluation of control deficiencies has been cited as one of the most taxing and time consuming requirements for auditors in their efforts to classify deficiencies accurately (Sentar, 2007). This classification is important, because auditors are required to report an adverse opinion on internal controls in the event that they identify material weaknesses in internal controls. If they only find significant deficiencies or control deficiencies, the auditor can issue an unqualified report on internal controls. While not required, auditors may also decide to disclose within an unqualified report any deficiencies that they decide would be important to emphasize (PCAOB, 2007).

Although the discovery of material weaknesses in internal control requires the auditor to issue an adverse opinion on internal controls (See Figure 1), this does not necessarily result in any modification to the auditor's opinion on financial statements. If the auditor decides that the material weakness has not resulted in a misstatement of the current year financial statements they are able to issue an unqualified opinion on the financial statements, but must explain why they came to this conclusion (PCAOB, 2007). This practice is quite common, as a material weakness

in internal controls only suggests the potential for misstatements to occur (PCAOB, 2007).

Therefore, some argue that the auditor's opinion on internal controls provides more of a signal of the potential for controls to *prevent* future material misstatements than assurance that the current statements are presented fairly (Cunningham, 2004).

The auditor's responsibility for reporting on internal controls, as described in the paragraphs above, has been argued to significantly increase liability for auditors which are passed down to the client in the form of increased fees (Asare et al., 2007). This increase in costs related to Section 404 reporting has sparked a large amount of research debating whether the benefits are worth the excessive costs and unintended consequences that have been associated with the legislation (Boyle and Webb, 2007). The sections below provide a discussion of this debate to gain an understanding of the costs and benefits of Section 404.

Research on Section 404: Are the Benefits Worth the Costs?

The auditing and reporting processes required by Section 404, as described above, are often cited as a significant source of increased costs to public companies. These costs occur as a result of the effort and resources needed to effectively comply with the provisions of Section 404 (Krishnan et al., 2008). These costs have been primarily attributed to increased audit fees, labor costs generated internally, and investments in new technology (Krishnan et al., 2008). Extensive amounts of labor and resources are necessary to effectively implement the requirements of Section 404. For example, managers must conduct their own assessment of internal controls, both on a periodic and continuing basis, and are responsible for making sure that any weaknesses are corrected in a timely manner. This often requires significant labor and investment in technology to improve internal controls over financial reporting. Compliance costs have been

estimated from an average of \$2.2 million (Krishnan et al., 2008) to \$3.14 million (Tackett et al., 2006) per company. Labor hours needed to comply with SOX have been estimated at 24,000 hours per company (Tackett et al., 2006). Audit fees have also been cited for the marked increase in costs, with increases in fees of 50% or more (Tackett et al., 2006). Critics of Section 404 assert that the increased requirements placed undue financial stress on companies, particularly smaller companies (Ezrati, 2007). Some additionally propose that the excessive costs of SOX have influenced companies' decisions to go private, as the benefits of being a public company are weighed against the costs to comply (Engel et al., 2007).

In contrast, others believe that these increased costs are worth the short-term financial stress, and that firms investing in their internal control foundations will most likely see long-term benefits of increased productivity (Bedard et al., 2007). Having high standards for internal controls within a company should decrease the likelihood of errors and fraud (Dyck et al., 2007), and significantly improve financial reporting by discouraging earnings management. This notion has been substantiated by archival research that indicates companies with material weaknesses in their internal controls are more likely to manage earnings (Doyle et al., 2007; Ashbaugh-Skaife et al., 2008; Chan et al., 2008). Research also indicates earnings management is particularly evident when the weak internal control is considered less auditable, such as the control environment (Doyle et al., 2007), and that firms who resolve their internal control weaknesses in following years tend to have less earnings management activity than firms who do not resolve their weaknesses (Ashbaugh-Skaife et al., 2008). Since earnings management is often viewed as an indicator of low quality financial reporting, this research indicates that Section 404 reports may be informative for users as a signal that financial reports may be less reliable which

provides a strong argument to support the proposal that internal control improvements can lead to higher quality financial reporting.

In addition to improving reporting quality, research suggests that Section 404 reports provide valuable information to external users. For example, lenders' are less inclined to rely on the financial statements when an adverse opinion on internal controls is issued, indicating that internal control weaknesses may signal users to question the reliability of financial statements (Schneider and Church, 2008). Although research supporting this proposition is mixed (Boyle and Webb, 2007), some have found that the market tends to react to companies who disclose material weaknesses in internal controls (Hammersley et al., 2008). Overall, research generally appears to indicate that external users are absorbing the information contained in Section 404 reports, and that the reports contain useful information.

While Section 404 provides benefits in the form of improved internal controls and useful information to users, some researchers suggest that the legislation created excessive amounts of liability exposure for the auditor when a negative event associated with a client occurs (Cunningham, 2004). The root of this argument is based on the additional disclosures contained within the Section 404 report, which indicate that auditors are now responsible for not only detecting misstatements in their financial audit, but for preventing future misstatements (Cunningham, 2004). The following section discusses this prospect, and provides a more in depth review of how Section 404 impacts auditors' exposure to legal liability given the current legal and regulatory environment.

SOX Sections 301 and 407: Provisions on Audit Committee Composition

Sections 301 and 407 provides guidance and requirements for the establishment of high quality audit committees. Audit committees function as the primary contact with external auditors for hiring decisions and as an intermediary between the auditor and management when disagreements occur during the audit (DeZoort et al., 2008). Auditors are required to communicate important matters to the audit committee, such as the identification of significant deficiencies in internal controls (Cohen et al., 2008). Overall, the audit committee is considered a key element of the corporate governance of a company as well as a crucial part of the financial reporting and auditing process (Jennings et al., 2006).

Research indicates that the post-SOX role of the audit committee has increased, as audit committee members are becoming more involved in the auditing and financial reporting process (DeZoort et al., 2008). In recent research, increased scrutiny has been placed on the specific characteristics and composition of the audit committee (Cohen et al., 2008). In particular, the research related to SOX provisions for audit committees has focused mainly on the issues related to the independence (Section 301) and expertise (Section 407) of audit committee members. These particular provisions still provide some flexibility and may account for much of the remaining variation in the effectiveness of audit committees (Zhang et al., 2007).

Section 301 designated that “each member of the audit committee... shall be a member of the board of directors of the issuer, and shall otherwise be independent” (U.S. House of Representatives, 2002, p. 32). The definition of independent as defined by SOX requires that the member not “accept any consulting, advisory, or other compensatory fee from the issuer” or “be an affiliated person of the issuer or any subsidiary” (U.S. House of Representatives, 2002, p. 32). Specifically, to be considered not affiliated the individual must own less than 10% of the stock of

the company (U.S. House of Representatives, 2002). The SEC also allows exemptions for companies that could result in a less than 100% independent audit committee. Since audit committee members can be shareholders, and the SEC makes exceptions for some companies that allow non-independent individuals to serve as audit committee members, there still remains some variation in the level of independence among public companies (Zhang et al., 2007).

Section 407 requires that companies disclose whether their audit committee contains at least one expert member. This member can be either an accounting expert or a financial expert. Accounting experts should have experience as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer (U.S. House of Representatives, 2002; Zhang et al., 2007). Financial experts should have experience as a chief executive officer, president, or chairman of the board in a for-profit corporation, or who has experience as the managing director, partner or principal in venture financing, investment banking, or money management (U.S. House of Representatives, 2002; Zhang et al., 2007). This particular audit committee requirement has received much attention from researchers, as the flexibility of the standard has created a large amount of variation in audit committee characteristics across companies (Bedard et al., 2004).

Research on Audit Committee Composition

Overall, the response to the Audit Committee composition provisions for expertise (Section 407) and independence (Section 301) as outlined by SOX has been positive, as both researchers and practitioners are in agreement that high levels of expertise and independence are associated with multiple indicators of higher quality financial reporting (Cohen et al., 2007).

Research on audit committees generally concludes that, as the interests of managers may not

always be aligned with that of the shareholder, audit committees fulfill an important role in the financial reporting process as providers of additional assurance that management is acting in the best interests of the shareholder (DeZoort et al., 2002). Audit committees are not involved in the day-to-day operations of the company, and provide a form of oversight of the financial reporting process that is considered a necessary element of corporate governance (DeZoort et al., 2002). However, not all audit committees are deemed equal in quality, and different audit committee characteristics have often been associated with varying levels of auditing and reporting quality.

One characteristic that has been highlighted in past research is the importance of an audit committee containing members that are qualified, have the authority, and have the resources available to provide effective oversight (DeZoort et al., 2002). One widely accepted taxonomy of audit committee characteristics identifies the following four important components to audit committee composition: expertise, independence, integrity, and objectivity (DeZoort et al., 2002)³. All four of these components are considered highly important to maintaining a high quality audit committee. However, expertise and independence have been the primary focus in past research on audit committee composition. This trend of research may have occurred because regulators and standard setters have placed an emphasis on improving these particular audit committee characteristics. This emphasis is evidenced by Sections 301 and 407 of SOX, which is the most recent attempt to regulate audit committee expertise and independence. The following sections provide a detailed discussion of the research related to audit committee expertise and independence.

³ In addition to identifying characteristics of audit committee composition as an important dimension to audit committee effectiveness, this taxonomy identifies three other elements: authority, resources, and diligence. See DeZoort et al. (2002) for more details on these audit committee qualities.

Audit committee independence

Independence has been viewed by researchers as the most important characteristic of an audit committee member (DeZoort et al., 2002). Overall, research indicates that higher levels of independence on audit committees promote higher quality financial reporting (DeZoort et al., 2002). However, the definition of independence is quite varied, ranging from the most lenient (i.e., as anyone who is not directly employed by the company in a capacity other than a board role), to more stringent suggestions (i.e., individuals who have no financial ties to the company in any way other than audit committee-related monetary compensation) (Chan and Li, 2008). Past studies most often measure independence as the percentage or number of outside members (i.e., members not compensated by the company in any role other than board membership), or the percentage or number of members with some type of stock ownership in the company (Bedard et al., 2004). Some have identified grey area directors, who may have additional ties to the company that may not violate any formal independence requirements, but still provide the potential to impair objectivity, such as family members or close business associates (DeZoort et al., 2002; Chan and Li, 2008).

Many studies suggest that audit committee independence is a contributing factor to a high quality audit (DeZoort et al., 2002). For example, audit committees with more independent members are more likely to hire auditors that specialize in their particular industry (Abbott and Parker, 2000), and end up paying significantly more audit fees (Carcello, 2002), both of which provide a solid argument that independent members may be more motivated to pursue the highest quality audit possible for the company. Research also indicates audit committees that are entirely independent are more likely to promote situations where auditors will be more independent as well, as evidenced by the association between higher audit committee

independence and lower non-audit fees for auditors (Abbott et al., 2003). In addition, companies in financial distress are more likely to receive a qualified audit opinion and less likely to change their auditors when the audit committee is more independent (Carcello and Neal, 2000; Carcello and Neal, 2003). Overall, these results provide evidence to support the argument that independent audit committees appear to demand higher quality audits, which is strong support for the importance of the independence provisions of SOX.

Audit committee independence has also been associated with indications of higher quality financial reporting (DeZoort et al., 2002). For example, audit committee independence is associated with fewer incidents of SEC-led fraud investigations (Abbott and Parker, 2000). Research also indicates that higher levels of independence of audit committee members are associated with lower abnormal accruals, a common measure of financial reporting quality (Klein, 2002; Bedard et al., 2004). Finally, firms with higher levels of audit committee independence are less likely to restate earnings, a factor which has also been commonly deemed as a measure of reporting quality (Abbott et al., 2004). Overall, this stream of research provides support for the argument that independent audit committees provide more effective oversight of the financial reporting process, thus leading to improved financial reporting quality.

Higher levels of audit committee independence are also associated with other positive company traits, such as higher firm value (Chan and Li, 2008), and lower incidence of internal control issues (Krishnan, 2005). Stakeholders of firms also seem to value the independence of audit committees. For example, firms with entirely independent audit committees tend to have a lower cost of debt, indicating that creditors may perceive these companies as lower risk (Anderson et al., 2004). In conclusion, there appears to be a consensus in research that having high levels of independence in an audit committee can have a positive impact on the reporting

and auditing processes, and the SOX provisions related to independence appear to be well accepted in both research and practice.

Audit committee expertise

The expertise of audit committee members has become a popular topic of recent research, motivated by the Section 407 requirement for companies to report whether they have at least one expert member on the audit committee (U.S. House of Representatives, 2002). A wide body of literature expresses agreement that expertise is an important element of the characteristics of an audit committee, due to the complex nature of the issues that are often discussed as part of a financial audit and reporting process (DeZoort et al., 2002). SOX requirements are still somewhat vague and allow for a large amount of discretion in this definition, as the member can be deemed as either an expert in accounting or finance. This particular issue, how to measure expertise, has been a large component of the recent research in this area, as different measurements of expertise tend to lead to different results (DeZoort et al., 2002).

SOX states that accounting-specific expertise is one way members of the audit committee can qualify as independent (U.S. House of Representatives, 2002). Accounting expertise in past research been defined as having experience as a public accountant, auditor, principal or chief financial officer, controller, or principal or chief accounting officer (Defond, 2005; Zhang et al., 2007). This definition has been utilized in multiple studies to measure the percentage of audit committee members that are deemed accounting experts, a characteristic which has been linked to significant positive abnormal returns following the appointment of such an expert (Defond, 2005). Accounting experts, as defined above, are also linked to a lower occurrence of internal control issues (Zhang et al., 2007). Another common way to measure accounting-specific

expertise on audit committees has been to identify whether members are Certified Public Accountants (CPAs) (McMullen and Raghunandan, 1996; DeZoort et al., 2008). Research utilizing this measure suggests that companies experiencing financial reporting issues (i.e., SEC investigations or restatements of earnings) were less likely to have CPA's on their audit committees, indicating that audit committees containing accounting experts may promote higher quality financial reporting (McMullen and Raghunandan, 1996). An increase in the number of CPA's on audit committees following SOX also appears to have improved communication between auditors and audit committees, and contributed to an increase in the likelihood that audit committees will side with the auditor in the event of a dispute between managers and auditors (DeZoort et al., 2008). This is an important finding, as the researchers suggest that audit committees, and ultimately auditors, have more power over reporting outcomes, and are utilizing this power to enforce more conservative reporting decisions (DeZoort et al., 2008).

Another option to qualify as an expert member of the audit committee is to be a financial expert; commonly defined as “a non-accounting financial expert who has experience as the chief executive officer, president, or chairman of the board for-profit corporation, or who has experience as the managing director, partner or principal in venture financing, investment banking, or money management” (Zhang et al., 2007, p. 7). Committees containing expert members utilizing this particular definition of audit committee financial expertise have been associated with lower abnormal discretionary accruals (Xie et al., 2003), and are less likely to be involved in a restatement of earnings (Abbott et al., 2004), both of which are often perceived as indicators of higher quality reporting. Firms with financial experts as audit committee members are also less likely to have issues with their internal controls (Krishnan, 2005).

Although this wide body of research on audit committee expertise generally indicates that expert members on audit committees are associated with higher quality reporting, no clear consensus has been reached on which types of expertise are most valuable. However, since different types of expertise are associated with different outcomes, as described in the paragraphs above, companies may be able to choose which qualities are most important to their current situation, and develop the audit committee based on their specific priorities.

Overall Conclusions: Audit Committee Characteristics

Overall, research indicates that both independence and expertise are important characteristics of audit committee members (DeZoort et al., 2002), with some support that high levels of both characteristics may be important for creating an effective level of oversight and corporate governance on audit committees for public companies (Krishnan, 2005; Chan and Li, 2008). Since SOX still offers some opportunity for variation in audit committee member independence and expertise, there are still unanswered questions for future research on audit committees (Lutzy, 2003). For example, perceptions of auditor independence may be tied to audit committee independence and/or expertise, which can potentially impact the auditor's legal liability exposure and the assessment of blame in the event of an audit failure. Past research indicates that judges may consider elements of corporate governance when forming opinions of auditor independence (Jennings et al., 2006). However, more research is needed to examine how the individual or combined characteristics of auditor expertise and independence could uniquely impact jurors' perceptions of auditors.

Auditor Legal Liability Exposure

Both research and practice have indicated that Section 404 increased the litigation exposure for auditors, and that auditors pass this cost on to clients with in the form of higher audit fees (Cunningham, 2004). This increase in litigation exposure was primarily due to the increased responsibility placed on auditors for Section 404 reporting. Since SOX did not modify the current laws and regulations governing how auditors can be sued, many argue that this increased liability exposure is excessive and could lead to an increase in frivolous lawsuits (Cunningham, 2004). The sections below provide an understanding of the legal environment in which audit firms operate. First, the laws and regulations are summarized to provide an understanding of the types of litigation that most concerns auditors. Then, research on auditor liability is discussed to understand the conditions that most likely lead to auditor litigation and unfavorable trial outcomes.

Laws and Regulations

Auditors are subject to legal liability from multiple statutes and laws, both at the state and federal level. Currently, many argue that auditors are most vulnerable to monetary losses for liability under federal law protecting the sales and purchases of securities, as indicated by evidence of over \$14 billion paid by U.S. accounting firms in securities related cases over the past three decades (Talley, 2006). Although some of this liability has been a result of SEC action, a large portion is also attributed to class action lawsuits initiated by shareholders. Specifically, Section 10b-5 of the Securities Exchange Act of 1934 (Exchange Act of 1934) (USC, 1934) and Section 11 of the Securities Act of 1933 (USC, 1933) allow for private courses of action against the auditor when shareholders sustain losses associated with securities (Asare et

al., 2007). Auditors are also open to enforcements from the SEC, and criminal liability under the Exchange Act of 1934 or other anti-fraud statutes at the federal level (Talley, 2006). At the state level, auditors are exposed to being sued for negligence under tort law. Audit firms have argued that lawsuits filed at the state level pose the largest exposure to excessive and unnecessary liability for auditors, primarily because of the lack of consistency in how laws are interpreted and applied in state courts (Talley, 2006).

The Exchange Act of 1934 has been cited as a source of increased liability exposure resulting from Section 404 reporting (Asare et al., 2007). This act allows for private action when the plaintiff can link monetary losses to an act of recklessness on the part of the auditors (Talley, 2006). Since the Exchange Act of 1934 was implemented, The Private Securities Litigation Reform Act of 1995 (USC, 1995) along with clarifications in court have increased the burden of proof for those seeking damages from auditors. The plaintiff must now prove both a monetary loss and reliance on disclosures which provides clear limitations to auditor liability exposure under the Exchange Act of 1934 (Geiger and Raghunandan, 2001; Talley, 2006).

Some argue that the additional disclosures required by Section 404 provide a new excuse for suing the auditor under the Exchange Act of 1934 (Talley, 2006). In past lawsuits, auditors most likely were implicated as secondary actors (i.e., aiding and abetting in fraud) as opposed to primary actors (i.e., directly active in committing fraud), as most of the cases were brought against the auditor for omitting information that would have influenced the shareholders' decision to purchase or sell stock (Asare et al., 2007). Auditors' classification as a secondary actor in past lawsuits was motivated by the fact that auditors were not required to report on internal controls, thus preventing auditors from being held liable as a primary actor for disclosing false and misleading statements under the Exchange Act of 1934 (Asare et al., 2007). However,

the language required in Section 404 reports potentially exposes auditors to additional liability when they specifically discuss material weaknesses and the resulting impact on the financial statements (Asare et al., 2007). This particular requirement arguably creates a situation where auditors may be exposed to more liability for even mentioning material weaknesses (Asare et al., 2007).

An additional source of liability cited as a significant issue in the current legal environment is at the state level. Currently, there is a large overlap between federal and state laws. Class action lawsuits that are filed citing the Securities Act of 1933 or the Exchange Act of 1934 must be tried in federal court (Talley, 2006). However, class action suits can still be tried at the state level under common law tort principles. The class action suit at the state level allows for punitive damages when the auditor is negligent in performing the audit, as long as the plaintiff can prove that the auditor should have been able to reasonably foresee the possibility that users, such as creditors or shareholders, would rely on the auditor's statements (Talley, 2006). This particular liability exposure has been highly criticized by auditors, as it does not require any proof of intent to mislead (*scienter*), as would the Exchange Act of 1934 (Talley, 2006). All the plaintiff must prove is negligence, or that the auditor did not perform to a minimum standard of care during the audit (Talley, 2006). The fact that state courts oversee these trials has been criticized for a lack of consistent application of the standards. As a result, audit firms petitioned the U.S. Treasury Committee to limit their liability to federal courts under the Securities Act of 1933 and the Exchange Act of 1934, and to prohibit class action lawsuits at the state level under tort law (Sukhraj, 2008). However, the committee recently issued a report indicating that they did not come to a consensus on this matter, and decided not to form an opinion or make recommendations to Congress related to this particular suggestion. Therefore,

auditors remain exposed to liability at the state level under tort law for negligence (Advisory Committee on the Auditing Profession, 2008).

Some researchers believe that the increased liability exposure for auditors described in the paragraphs above is a positive side effect of SOX (Krishnan et al., 2008). The general argument to support this perspective is that this increased litigation risk motivates auditors to increase quality and effort; thus, the additional audit costs attributed to litigation risk are worth the benefit (Krishnan et al., 2008). Others argue that this additional liability exposure is excessive to the detriment of the audit industry as a whole, and the increased costs passed down to their clients are not worth the minimal assurance provided with additional audit efforts (Cunningham, 2004). Research indicates that, although jurors may be inherently biased against the auditor, contextual factors about the case can influence perceptions of the auditor. These contextual factors can influence whether the auditor will be sued or will be found blameworthy in a trial setting. Some research indicates that the changes imposed by SOX may in fact have a positive impact on auditor litigation outcomes (Jennings et al., 2006). The following sections provide an overview of attribution theory and a discussion of how decisions are made in jury trials. This is followed by a discussion of the contextual factors that can impact the likelihood of auditor litigation and outcomes of trials.

Attribution Theory and Juror Decisions

Attribution theory is often employed to explain how jurors and judges construct their decisions (Arrington et al., 1985). This theory suggests that there are antecedents and consequences to attributions (Kelley and Michela, 1980). Antecedents are circumstances or specific elements that tend to influence an individuals' perception of the motivation behind

another person's decision (Kelley and Michela, 1980). For example, the juror may either believe that the auditors made decisions based on internal reasons (i.e., professional judgment) or external reasons (i.e., pressures from client, time pressure, compliance with strict rules, etc.). This perception is often presumably based on the jurors' belief of how much power the auditor had over their decisions (Kelley and Michela, 1980). These perceptions can be based on a number of things, such as the individuals' beliefs and expectations or contextual factors related to the specific situation.

According to attribution theory, this judgment of internal vs. external motivation has an impact on the individual's decision (Kelley and Michela, 1980). For example, when a juror perceives the motivation for an auditor's decision to be internal, they are more likely to attribute the control over the decision to the auditor and expect that the auditor will rely on professional judgment. When the motivation is seen as external, they are more likely to perceive that the auditor was under pressure to make a specific decision, and therefore had less control over their decision. Research has shown that observers, such as jurors and judges, are more likely to attribute acts to external motivational factors, which is called *attributional bias* (Lipsitt and Sales, 1980; Block and Funder, 1986; Olgoff, 2003). In addition, when jurors perceive the environment to be controllable or not controllable, they evaluate auditors more or less harshly (Becker et al., 2007).

Outcome Effects: Bias against Auditors in a Trial Setting

One form of bias in juror and judge decisions is the widely researched notion of outcome effects (Lowe and Reckers, 2006)⁴. Outcome effects are biases that are said to occur because jurors are aware of the outcome of an event during a trial (i.e., a company bankruptcy, significant stakeholder losses). Therefore, when the individual is asked to judge an auditor's decisions and actions based on the auditor's knowledge before the event occurred, they are not able to be objective (Lowe and Reckers, 2006). Research has supported the existence of outcome effects, finding that jurors and judges both tend to make harsher judgments when they are aware of the outcome and when an outcome is more severe (Hawkins and Hastie. 1990; Lowe and Reckers 1994; Becker et al., 2007). Some have proposed ways to mitigate this bias, such as specifically addressing and discrediting the negative bias during the trial (Kadous, 2001), or drawing attention to the likelihood of an audit failure in a specific situation (Peecher and Piercey, 2008).

Many have also found that accountants are less inclined to exhibit outcome bias than non-accountants (Arrington et al., 1985), which indicates that there may be a difference in the reasoning between the groups. This additional complication to juror decisions is the concept of the 'expectation gap', which is the difference between what a juror perceives the auditor's responsibilities to be and what an accountant perceives the auditor's responsibility to be (Frank, 2001; Lowe and Reckers, 2006). Researchers suggest that this difference is based on non-accountants' lack of understanding of the audit process, or perhaps a pre-conceived negative opinion of auditors (Frank, 2001; Lowe and Reckers, 2006).

⁴ See Lowe et al. (2006) for a detailed review and synthesis of prior literature on outcome effects and juror/judge decisions about auditor liability.

Contextual Factors Contributing to Auditor Liability Exposure

Other studies in this area do not focus primarily on juror bias, and instead examine the conditions under which auditors are exposed to the least amount of liability. Many of these studies are motivated by empirical/archival research, which often provides valuable information to identify basic relationships between characteristics of the audit or company and the auditor's likelihood of being sued. These studies primarily examine how contextual factors can lead to the auditor being sued and influence trial outcomes. Some studies examine contextual factors within a behavioral setting to isolate specific factors that could influence decisions of jurors and judges. The following paragraphs discuss the main conclusions provided by both empirical/archival research and judgment and decision-making research on auditor litigation to provide a comprehensive understanding of the combined insights of the research areas.

One common stream of research identifies factors that are most likely to lead to litigation involving the auditor. These studies consistently find a link between increased auditor litigation and audit clients with a larger size, restatement activity, bankruptcy, and publicly traded status (Fuerman, 1997; 1998; 1999; Latham and Linville, 1998⁵). In addition, clients in the technology manufacturing, finance, real estate, and insurance industries are more likely to expose the auditor to litigation (Latham and Linville, 1998). Further, the presence of fraud tends to increase the likelihood that the auditor will be sued, particularly when the fraud is more prevalent or common and when there is evidence of fraudulent transactions (Bonner et al., 1998). This research indicates that perhaps the nature of the fraud can influence expectations of the auditor, and the perceptions of whether the auditor was negligent for not discovering and disclosing the fraud.

⁵ See Latham and Linville (1998) for a detailed review of the research on auditor litigation up to 1998.

Research indicates that other factors, such as disclosure quality, may actually *decrease* the likelihood that the auditor will become involved in litigation. Other findings that play a role in predicting whether auditors will be involved in litigation include the general perception of the audit firm and the amount of effort the auditor made during the audit. First, the size of the audit firm is important, as larger audit firms are consistently associated with less litigation (Palmrose, 1988). This particular finding has been used to argue that large audit firms are associated with higher audit quality (either actual or assumed); therefore, they are sued less often (Latham and Linville, 1998). The disclosures made by auditors are viewed as a key component of the reporting process, as the disclosures reduce information asymmetry that exists between the managers and stakeholders of companies (Healy and Palepu, 2001). Therefore, research proposes that auditors can potentially impact their risk of litigation by how well they communicate information in their reports; disclosure quality combined with an underlying audit quality can effectively deter litigation risk (Latham and Linville, 1998).

Perhaps the first of these studies to find a link between auditor disclosure and litigation risk is a study conducted by Carcello and Palmrose (1994) that proposes that auditors issuing timely modified going concern opinions, which can warn of possible going concern issues but stop short of qualifying the audit opinion, can reduce the likelihood that the auditor will be sued when their client ends up in bankruptcy. Further supporting this argument, a recent behavioral study examining audit disclosures and litigation risk finds that potential litigators may be less likely to recommend suing the auditor when the auditor has provided a red flag in the form of a modified audit opinion that warns of a possible going concern issue with the company (Mong and Roebuck, 2005). Therefore, the auditor's disclosures are important as a potential signal to stakeholders of bankruptcy risk. Krishnan and Zhang (2005) also find that voluntarily providing

a quarterly review report is negatively associated with auditor litigation, and that the market positively responds to the release of such a report. Overall, these studies provide evidence supporting the idea that auditors may be able to decrease their litigation exposure by signaling quality audits (Latham and Linville, 1998), particularly by providing disclosures that create signals to stakeholders concerning future risks within the company (Mong and Roebuck, 2005).

Another recent stream of research in this area identifies the factors that are most likely to lead to a favorable outcome in litigation involving the auditor. This research focuses primarily on how current changes within the audit environment may impact trial outcomes. Although the current trend is for auditors to settle out of court, understanding how court decisions are made is still important, as audit firms and their legal counsel rely heavily on their expectations of what will occur in court to make decisions of whether or not to settle, and how much the settlement should be (Brandon and Mueller, 2008). The pool of litigation cases that result in actual trial outcomes with a judge and jury is quite small, which leads to difficulties for researchers attempting to develop an understanding of jury trial outcomes (Latham and Linville, 1998). As a result of this small data pool, the predominant method for examining litigation outcomes in this particular light has been in a behavioral context. This type of research can provide valuable insights about how suggested, pending, or recent changes in the audit environment can influence litigation outcomes. Therefore, the conclusions reached by examining juror and judge decision-making is highly relevant to the current debate on auditor's legal liability exposure, particularly as it relates to how SOX and other recent changes have influenced the likelihood of auditors being held liable in courts.

Past research on auditor liability is consistent with behavioral law research, such that perceptions of the defendant are often important when deciding blame (Brandon, 2006; 2008).

For example, studies indicate that perceptions of auditor independence and audit quality are important to judges and jurors, and that these perceptions can be influenced by circumstances of the case (Jennings et al., 2006). In a recent study conducted with U.S. judges, researchers found that perceptions of independence are highest when the auditors were identified as working with clients who had corporate governance characteristics that are beyond the minimally compliant levels of corporate governance, and under conditions of audit firm rotation (Jennings et al., 2006). This study suggests that an overall high level of corporate governance is desirable for auditors when choosing clients, and that auditor tenure can influence perceptions of auditor independence. In another recent study examining auditor tenure, researchers found that auditor tenure negatively impact jurors' perceptions of auditor independence, but positively impacts their perceptions of auditor competence (Brandon and Mueller, 2008). As perceptions of auditor independence were found to increase blame, and perceptions of competence were found to decrease blame, perceptions of auditor tenure may be a double edged sword and that the issues must be strategically addressed in court (Brandon and Mueller, 2008). Perceptions of client importance have also been found to influence perception of auditor independence, resulting in a negative relationship between client importance and independence (Brandon and Mueller, 2006). The inverse link between perceptions of auditor independence and blameworthiness, which appears to be a common factor in recent research in this area, has also been confirmed (Brandon and Mueller, 2006). Overall, these studies indicate that one of the main goals of SOX legislation, increasing auditor independence, may have a significant (positive) impact on how auditors are perceived in a trial setting.

The Impact of Litigation: Reputation Loss

Audit firms claim they are exposed to both monetary losses and reputation losses in the event of litigation. Auditors estimate that they are currently exposed to billions of dollars in damages should the current cases against them result in negative outcomes (Sukhraj, 2008). In addition to exposure to potential monetary losses, reputation loss has been cited as one of the most detrimental side effects of litigation, as reputation loss can ultimately lead to monetary losses with the increased threat of clients abandoning the audit firm (Barton 2005; Krishnamurthy et al., 2006). For example, an audit firm's non-litigating clients experience an immediate negative reaction in financial markets when an auditor is announced to be associated with litigation (Franz et al., 1998). This implies that markets do consider the quality of an auditor's work when valuing their clients and that lower audit quality is automatically assumed by the auditor's involvement with litigation. The findings of Franz et al. (1998) suggest that being associated with litigation, no matter what the outcome, has the potential to negatively impact an audit firm.

Recent studies have examined one specific event that is placed at the center of audit firms' pleas for liability limitations--the demise of Arthur Andersen. Some researchers suggest the reputation losses suffered from a string of failures of Andersen's high profile clients started the decline of this firm, initially leading to large clients withdrawing from the audit firm's services (Barton, 2005). As a result of highly publicized press releases related to the case (i.e., document shredding, federal indictments, publicity surrounding the firm's significant non-audit fees, etc.), the firm began to suffer further reputation losses from a declining public perception of the firm's audit quality and independence (Chaney and Philipich, 2002; Krishnamurthy et al.,

2006). Researchers argue that these reputation losses were instrumental in bringing down the company, as clients did not wish to be associated with a firm with such a poor public perception of audit quality (Barton, 2005; Krishnamurthy et al., 2006).

Others question whether the reputation losses argued to be a significant factor in the demise of Arthur Andersen are valid. Such critics suggest instead that Andersen's clients experienced a downturn in the market driven by other events that occurred within the same time frame (Nelson et al., 2008). This alternative argument undermines one of the key arguments supporting the notion that reputation losses that occur solely from the announcement of litigation can directly lead to monetary losses for audit firms. The conditions surrounding the specific case of Arthur Andersen also suggest that perceived audit quality is important, as clients did not begin to abandon the firm until it was clear that the public perceived their audits to be substandard (Chaney and Philipich, 2002; Krishnamurthy et al., 2006). Overall, the conclusions reached concerning the Arthur Andersen case may provide further support for the argument that audit quality and increased standards for independence that are provided by SOX can have a positive impact on auditor liability exposure, by perhaps decreasing the potential for negative repercussions by being associated with litigation.

Using the collapse of Arthur Andersen as an example, auditors recently argued to the U.S. Treasury Department's Advisory Committee on the Auditing Profession that both the monetary and reputational losses associated with frivolous lawsuits are placing other auditing firms at risk of a similar fate. This example, combined with their arguments that SOX opens up the auditors to an even greater liability, provided the foundations for the arguments that liability limitations are crucial in order to prevent another large audit firm from collapsing under the strain that could occur with another large audit failure (Sukhraj, 2008). Although some members

on this committee recognized that the current litigation exposure of auditors might threaten the future of large audit firms, the committee members expressed different opinions on how this issue should be addressed. Other committee members disagreed with the audit firms' argument that their litigation exposure is threatening enough to warrant changes in the current litigation environment. Overall, this committee's considerations were inconclusive on the issue, citing that members were not able to reach a consensus (Advisory Committee on the Auditing Profession, 2008). In light of the current market conditions that could lead to an increase in litigation exposure following the decline of financial markets, researchers have an opportunity to contribute to future discourse on auditor litigation by gaining a better understanding of the links between litigation and reputation losses, as well as how audit quality influences the initiation and outcome of litigation involving auditors. Not only could this information be used to assist future legislators and regulators with their decisions on how to move forward with the auditor's requests for liability limitations, but audit firms could certainly benefit from a greater understanding of how to deal with their liability exposure as it currently stands.

Overall Conclusion

The contrasting viewpoints presented in paragraphs above concerning the debate over the link between reputation losses and the failure of Arthur Andersen highlight the difficulty of gaining a full understanding of the public's perception of auditors following an audit failure. This creates a strong argument for the need to examine the phenomenon from a behavioral perspective, which will enable isolation of key factors of the debate from economic events that occur within the same time frame. The studies reported in following chapters contribute to this understanding by examining specific components of SOX that could affect auditor liability

exposure. The overall conclusions reached by these three studies contribute to research on auditor liability, audit committee composition, and internal control reporting. Overall, these studies provide a link between the provisions of SOX and auditor legal liability, which has been identified as important in both research and practice, but not fully investigated empirically.

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STUDY ONE: SOX SECTION 404 AND AUDITOR LITIGATION EXPOSURE: AN INVESTIGATION OF POTENTIAL LITIGATORS' CONSIDERATION OF THE AUDITOR'S REPORT ON INTERNAL CONTROLS

Introduction

Section 404 of the Sarbanes Oxley Act of 2002 (SOX) significantly expanded auditors' responsibility for evaluating a client's internal controls (Parles et al., 2007). Section 404 requires the auditor to conduct an integrated audit of internal controls along with the audit of financial statements, and to express an opinion on internal controls based on the results of this audit (PCAOB, 2007). This increased responsibility for assessing and reporting on internal controls has been cited as the main source of audit fee increases following SOX implementation, as auditors have increased their efforts to assure that they meet the requirements of the legislation (Foster et al., 2007; Hogan and Wilkins, 2008; Krishnan et al., 2008). This upward trend in audit fees has also been attributed to an increase in liability exposure related to the new opinion and disclosures required by Section 404 (Asare et al., 2007).

Auditors claim that this increased liability exposure creates a litigation environment that is unfairly risky for auditors (Asare et al., 2007). Audit firms argue that the assessment of internal controls and the impact of control deficiencies on the financial statements is a highly complex process, requiring auditors to rely heavily on professional judgment (Tackett et al., 2006). Others argue that the auditor's report on internal controls provides disclosures that assure users that controls are in place to *prevent* material misstatement, which increases the culpability of auditors for internal control failures within a company (Asare et al., 2007). In addition to potential financial losses that may occur in the case of auditor litigation, auditors are exposed to reputation losses that accompany any attachment to a legal case (Chaney and Philipich, 2002).

Research suggests that the failure of Arthur Anderson may have been attributed to reputation losses, perhaps even before the indictment stage, and that monetary losses began long before any awards related to legal liability (Chaney and Philipich, 2002). Therefore, the reputation loss associated with a suit brought against an auditor can potentially have significant negative effects on the firm, no matter the outcome.

The purpose of this study is to examine whether auditors may be able to protect themselves from litigation by taking actions that will decrease the likelihood of being sued, specifically whether the auditor's opinion and disclosures required by Section 404 may be deemed to be red flags and deter litigation by potential litigators. Auditors are currently only required to disclose material weaknesses in internal controls, which are only those internal control deficiencies considered to have a potential material impact on financial reporting (Hammersley et al., 2008). Even when auditors report an adverse opinion on internal controls upon the discovery of a material weakness, they are not required to make any modifications to the auditor's opinion on the financial statements unless they have reason to believe that the financial statements are materially misstated (PCAOB, 2007). Therefore, the main purpose of this study is to investigate whether providing an adverse opinion on internal controls, or voluntarily disclosing significant deficiencies, is considered an adequate red flag to investors of the potential for material misstatements, even when the auditor provides an unqualified opinion on the financial statements. This red flag could be viewed as a signal to users that a potential failure in internal controls may lead to material misstatement and the ultimate failure of a company. Past research indicates that audit disclosures can lead to a decreased likelihood of litigation (Carcello and Palmrose, 1994; Krishnan and Zhang, 2005; Mong and Roebuck, 2005).

This study expands on this research by providing insight into the decision-making of lawyers considering a potential case against auditors.

To gain this enhanced understanding of lawyers' decisions, a 3x1 between subjects experiment was conducted with 100 lawyers specializing in business law and/or securities law, who provided their opinions about a potential shareholder lawsuit against an auditor of a bankrupt company. Participants were told that the auditor of a public company discovered a deficiency in internal controls during a previous audit, but failed to assess accurately the likelihood that the deficiency would result in a material misstatement of the financial statements for the company. This company eventually declares bankruptcy after discovering pervasive fraudulent financial reporting within the company, and participants were told that the shareholders of the company are exploring options to recover their losses. The SOX Section 404 report was manipulated across three conditions, with one condition communicating that the auditor had previously reported an unqualified opinion on internal controls with no disclosure of the deficiency the auditor found during the audit. The second condition communicated that the auditor reported an unqualified opinion on internal controls, but provided a voluntary disclosure of the deficiency, and the third condition stated that the auditor reported an adverse opinion on internal controls.

Results indicate that auditor litigation exposure is lower when the auditor reports an adverse opinion on internal controls, in comparison to reporting an unqualified opinion with or without disclosures. These results support the argument that an adverse opinion within the Section 404 report may be perceived as a red flag to users, resulting in a decreased likelihood of litigation. The findings of this study indicate that auditors should carefully consider Section 404 reporting decisions, as their reporting decisions related to internal controls may have a significant

impact on their litigation exposure. Since auditors' Section 404 reporting decisions are often subjective, the results of this study may provide important insight into how such decisions could influence the likelihood of the auditor being sued in the event of a client's bankruptcy. This implication is important, as the auditor's assessment of litigation risk directly influences the timing and extent of audit procedures and the resulting fees for the audit.

The following section provides a discussion of the requirements of Section 404 and the auditor's reporting decisions related to internal controls. Then, hypotheses are developed based on signaling theory to predict how potential litigators will perceive auditors under different reporting conditions, should the failure of a company be attributed to internal controls. An experiment is conducted to test these predictions, and results are discussed to understand the implications of the findings. Finally, overall conclusions, limitations, and future research opportunities will be highlighted to provide a summary of the overall contributions of this study.

Theory and Hypothesis Development

SOX Section 404: Responsibilities of the Auditor

SOX Section 404 requires additional assurance from the auditor in the form of an integrated audit on internal controls and financial reporting (McConnell and Banks, 2003). First, management is required to establish and maintain internal controls over financial reporting, and provide the annual release of their financial statements indicating whether their internal controls are sufficient to prevent or detect material misstatement. Then, auditors are required to perform their own independent procedures to evaluate internal controls and state their opinion on these controls with the Auditor's Report on Internal Controls (PCAOB, 2007).

The auditor's opinion on internal controls is formed based on the auditor's judgment on the likelihood that the company has sufficient internal controls in place to prevent or detect a material weakness in the financial statements. Figure 1 provides a detailed outline of the decision process described below which explains the relationship between the auditor's Section 404 opinion and their assessment of internal controls. There are three important definitions that provide guidance to assist auditors in forming their opinion on internal controls: control deficiencies, significant deficiencies, and material weaknesses. A *control deficiency* is "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis" (PCAOB, 2007, p. 57). Control deficiencies are very common within a company, and are often discovered by either management or the auditor. Once a control deficiency is identified, the auditor and/or management must then assess the likelihood of a material misstatement due to the deficiency. If the deficiency has more than a remote likelihood of leading to a more than inconsequential misstatement, then it is classified as a *significant deficiency*. If the deficiency is deemed to have the potential for a material misstatement, it is classified as a *material weakness* (PCAOB, 2007).

The differentiation between control deficiencies, significant deficiencies, and material weaknesses is important to the auditor's reporting decisions due to specific rules for the auditor's opinion on internal controls under different conditions. If only control deficiencies and significant deficiencies are identified, the auditor reports an unqualified opinion on internal controls (PCAOB, 2007). Although auditors of non-public companies are required to disclose significant deficiencies in their report on internal controls, no additional disclosures are required for public companies (AICPA, 2006). An adverse opinion on internal controls is required if the

auditor is aware of any material weaknesses in internal controls. This report would contain details on the material weakness and mention any steps management will take in the future to solve the problem. The auditor must then assess how material the weakness is to the financial statements, and consider modification of the auditor's opinion on financial statements. If the auditor deems the weakness to be contained and not have enough of an impact to warrant such a modification, the reasons for coming to this conclusion must be explained within the Section 404 report (PCAOB, 2007).

Signaling Theory and the Use of SOX Section 404 Reports

Although the PCAOB released AS-5 to clarify the provisions of SOX and provide implementation guidance specifically related to Section 404 reporting (PCAOB, 2007), the reporting decisions made by auditors are still highly ambiguous and at times may still lack clarity (Parles et al., 2007). For example, the differences between significant deficiencies and material weaknesses are difficult to assess, particularly when they are assessing both qualitative and quantitative materiality (Tackett et al., 2006). This decision relies heavily on professional judgment and arguably exposes the auditor to an increased amount of legal liability (Asare et al., 2007). Because of this potential increase in liability exposure, auditors appear to have increased their efforts to assure that they identify and assess control deficiencies effectively (Boyle and Webb, 2007). This strategy has led to a significant increase in audit costs, which have been attributed primarily to this increase in responsibility (Boyle and Webb, 2007; Krishnan et al., 2008).

Some argue that this additional cost is worth the effort, as Section 404 reports provide important information for stakeholders by signaling potential risks within the company related to

internal controls (Canada et al., 2007). Signaling theory is often utilized to understand why high quality information, such as audit reports, would be in demand even when such disclosures are costly to a company (Titman and Trueman, 1986; Bagnoli and Watts, 2005; Levine and Hughes, 2005). Although signaling theory originated in research investigating job searches and the interactions between potential employers and employees, this theory provides higher-level insights into human behavior when one party is privy to more information than another party, otherwise known as information asymmetry. Signaling theory suggests that as two parties interact, information will be exchanged when one party provides a signal that is interpreted by the other party. Once the signal is received, the decisions of the party receiving the signal are presumably influenced by the information, but only if they perceive the information to be reliable. Signaling theory suggests that reliability perceptions are influenced by many considerations, one of which is the perceived cost of providing the signal (Akerlof, 1970).

In past research, audit reports and related disclosures are often represented as one way that the information asymmetry between a company and stakeholders can be reduced (Healy and Palepu, 2001). Research also suggests that perceptions of the quality of such disclosures may influence how users perceive the company and impact the extent of influence the information has on their decisions (Latham and Linville, 1998). Consistent with signaling theory, past research indicates audit reports and disclosures matter to users as well as provide signals that are incorporated into the users' evaluation of the company. For example, the market responds to differences in audit opinions (Strawser, 1991) and disclosures within the audit report, such as an emphasis of a matter paragraph (Craswell, 1999). Research specifically indicates that the Section 404 report contains useful information, as investors tend to respond to different characteristics within this report (Hammersley et al., 2008), and loan officers use the reports to make loan

decisions (Schneider and Church, 2008). The results of past research are consistent with signaling theory. This research suggests that, although Section 404 reporting is costly to the company, the information provides a useful signal to both investors and creditors (Boyle and Webb, 2007).

Prior research also indicates that audit reports can limit an auditor's exposure to litigation by providing a signal to users indicating potential problems within a company (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). This finding is aligned with signaling theory, indicating that audit reports that are modified are perceived as costly to the auditor (i.e., increase the potential of losing the client), and users respond to the information contained in the report. Specifically, when auditors include an emphasis of a matter paragraph to warn users of a potential going concern issue with the company, they are less likely to be sued (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). Research also indicates that the market appreciates voluntary disclosures from auditors, as evidenced by a market reaction to the release of quarterly review reports (Krishnan and Zhang, 2005). Krishnan and Zhang (2005) also find voluntarily providing a quarterly review report is negatively associated with auditor litigation. These findings support the notion that certain audit disclosures may be deemed as sufficient signals to investors that a company may have problems in the future. These findings also indicate that potential litigators consider audit disclosures when deciding whether the auditor should be sued. Since auditors are motivated to avoid the incidence of lawsuits, for both the direct costs of litigation and indirect costs related to their reputation (Barton 2005; Krushnamurthy et al., 2006), such a finding may provide an incentive for auditors to increase the transparency of their audit reports by disclosing more details of their findings related to internal controls.

Overall, research indicates that users value the auditor's Section 404 opinion, and audit disclosures have the potential to reduce the likelihood of litigation (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). Therefore, this study investigates whether the additional reporting requirements of Section 404 may provide an opportunity for auditors to signal their concerns about a company without modifying the auditor's report on financial statements, and ultimately lessen their litigation exposure. This opportunity is important in light of the negative perceptions of how costly Section 404 is for firms. This information could provide additional incentives for auditors to conduct high quality audits and increase the transparency of their disclosures related to the audit of internal controls.

Although auditors of public companies are not currently required to make any disclosures related to significant deficiencies as long as they are deemed immaterial (PCAOB, 2007), this study proposes that auditors have an incentive to provide such disclosures voluntarily, even though the opinion on internal controls is unqualified. Such voluntary disclosures of significant deficiencies are already appearing in managements' reports on internal controls (Hammersley et al., 2008), but auditors have not currently taken this step in their own reports on internal controls. Neither party is expressly prohibited from disclosing significant deficiencies, but both management and auditors are only required to disclose specific details concerning significant deficiencies to the audit committee (Hammersley et al., 2008). However, disclosing significant deficiencies within the auditor's report on internal controls is required for audit reports of non-public companies (AICPA, 2006) and is similar in nature to including an emphasis of a matter paragraph within an unqualified auditor's report on financial statements (Mong and Roebuck, 2005).

Past research indicates that disclosures of significant deficiencies are important to investors (Hammersley et al., 2008). Therefore, a voluntary disclosure of deficiencies within the Section 404 report for public companies could provide the auditor a chance to communicate a potential problem with internal controls when there is not enough evidence to report an adverse opinion on internal controls. In the event that the auditor decides to issue an unqualified or clean report on internal controls, both signaling theory and past research suggests that providing additional disclosures to emphasize potential problems within a company can provide a red flag that will signal to users a potential issue within the company (Mong and Roebuck, 2005). The research in this area also indicates that a red flag signal can offer protection from liability exposure by decreasing the likelihood that litigation will be pursued against the auditor (Mong and Roebuck, 2005). This study proposes that, in the event that an undetected material misstatement is discovered after the issuance of the annual report that is directly attributed to a failure in internal controls, potential litigators will perceive the auditor's voluntary disclosures to be a red flag signaling risk in the company, and will adjust their evaluations of the auditor accordingly. Therefore, H1 is formally stated as follows:

H₁: Auditors reporting an *unqualified* opinion on internal controls *containing voluntary disclosures of control deficiencies* will be evaluated *more favorably* by potential litigators than auditors reporting an *unqualified* opinion on internal controls with *no additional disclosures*.

In the event that the auditors identify a control deficiency, they must then assess the likelihood of the deficiency leading to material misstatements. This materiality can be qualitative or quantitative, and is often highly subjective. If the weakness is determined to be material, the auditor must report an adverse opinion on internal controls as shown in Figure 1. However, even in the event that the auditor finds a material weakness and reports an adverse opinion on internal

controls, the weakness may not be pervasive enough to warrant modifying the opinion on the financial statements (PCAOB, 2007). In this case, the auditor would still indicate that the financial statements are reliable, even if an internal control weakness exists. However, the auditor's adverse opinion on internal controls explicitly states it is likely that a material misstatement in the financial statements will not be prevented or detected due to a weakness in internal controls, which is a much stronger statement of risk than what is suggested by a significant deficiency (see Figure 1). Therefore, an adverse opinion on internal controls arguably provides a stronger signal of potential material misstatement in comparison to an unqualified opinion, even if the unqualified opinion is accompanied by voluntary disclosures of significant deficiencies.

The ability of the internal control opinion (unqualified or adverse) to impact auditor liability exposure and likelihood of litigation in the event of an audit failure has not been examined by researchers. However, as signaling theory and past research indicates that an auditor's report containing signals that act as a red flag to potential litigators can lessen the likelihood of litigation, an adverse opinion on internal controls should theoretically provide a stronger signal of potential misstatements to users (Mong and Roebuck, 2005). In the event that an undetected material misstatement that is directly attributed to a failure in internal controls is discovered after issuing the annual report, potential litigators should consider an adverse opinion on internal controls to be a stronger red flag signaling internal control risk than an unqualified opinion on internal controls, with or without voluntary disclosures, and will adjust their evaluations of auditors accordingly. Therefore, H2 is stated as follows:

H₂: Auditors reporting an *adverse opinion* on internal controls will be evaluated *more favorably* by potential litigators than auditors reporting an *unqualified* opinion on internal controls *containing voluntary disclosures of control deficiencies* or an *unqualified* opinion on internal controls with *no additional disclosures*.

Research Method

A 3x1 between-subjects experiment was conducted to examine how the information contained within the auditor's report on internal controls can influence potential litigators' likelihood of attributing blame to the auditor in the event of an audit failure. Three different conditions were examined, with all three stating that the auditor reported an unqualified opinion on financial statements, and the manipulation occurring based on whether the auditor's opinion on internal controls was either (1) unqualified with no additional disclosures, (2) unqualified with additional disclosures of significant deficiencies, or (3) adverse (contains description of material deficiencies). Table 1 provides an overview of the research design.

Experimental Task and Procedures

Participants were presented with information about a company that recently declared bankruptcy following an announcement of the discovery that the company had falsely inflated revenue figures to conceal significant declines in demand for products. This announcement was accompanied by a significant downward restatement of income for previously reported financial statements. Shortly after this announcement, the company declared bankruptcy. The shareholders of the company sustained significant losses when the company declared bankruptcy, and the stock became worthless. The participants were presented with details about the previous years' audit, indicating that the auditor discovered a deficiency in internal controls. This particular deficiency in internal controls is determined to have been the primary facilitating factor in failing

to prevent or detect the falsely inflated revenue figures. After reviewing these details, the participants were provided the option of viewing the reports on internal control for both management and the auditor for 2007. Participants were then asked whether they viewed the reports and whether the reports influenced their decisions for the task. In response to this question, 72% of the participants indicated that they viewed the auditor's report, and 67% viewed management's report. On a scale of one (strongly disagree) to seven (strongly agree), the mean rating for decision relevance was 5.231 for management's report and 5.623 for the auditor's report, indicating that the reports were on average slightly relevant to somewhat relevant to their decisions. See Appendix B for a copy of all three versions of this case.

To increase the external validity of the case study, the main factors were developed based on actual court cases. The case study was then subjected to multiple rounds of edits based on direct feedback in the pre-test round from professionals with expertise in auditing, audit committees, securities law, tort law, accountants' professional liability, and litigation. In the pre-test round, five lawyers reviewed the case materials in depth and provided direct feedback on the understandability and external validity of the case. An anonymous pre-test of the online experiment was also conducted with six law students and five lawyers to further test the understandability of the case study materials. The case study was edited based on feedback from this pre-testing to assure that the appropriate legal terminology was used in both the case study and questionnaire.

Overall, the facts in the case were intended to reflect a scenario that would normally heighten the likelihood that the auditor would be sued, with a realistic pattern and timeline of events (i.e., undetected falsely inflated revenue figures, downward restatement of income, stock price decline, and bankruptcy). Many of these factors were identified as important by the lawyers

reviewing the case, who indicated that most lawyers would not consider a lawsuit against auditors if these particular conditions were not present. However, the scenario implies a high level of audit quality, as the auditor in the case identified a deficiency in internal controls during the 2007 audit and followed the appropriate procedures by reporting the discovery to the audit committee. Therefore, the ambiguity of the situation involves the auditor's Section 404 reporting decision, which was based on professional judgment of the evidence available at the time. As an additional measure of external validity, participants were asked, 'How realistic was this scenario?' using a Likert scale with one (not realistic at all) to seven (completely realistic), and answered with a mean response of 4.411 (slightly realistic).

In a similar manner to Mong and Roebuck (2005), participants were asked questions to gauge their understanding of the auditor's opinions, which provided assurance to the researcher that the manipulation was both read and understood by the participant. Then, participants were asked a series of questions to assess the likelihood that a lawsuit would be filed against the auditor, how strong the potential case against the auditor would be, and whether they would recommend that the shareholders pursue/not pursue litigation against the auditor. This series of questions was asked to gain an understanding of the litigation exposure of auditors in this scenario. Following this series of questions, the participants were prompted to provide predictions about the outcome of potential lawsuits against the auditor in this scenario. These questions were asked to provide a measure of the auditor's potential liability exposure in the event that they were sued. Participants were also asked to provide their opinions about a potential case against the audit committee and top management of the bankrupt company. Finally, participants were asked to provide demographic information to assess the likelihood that they are adequate representatives of individuals that could be placed in the situation where such decisions

would be made (i.e., income level, investment experience, education, career path, etc.). See Appendix B for a copy of the questionnaire provided to all participants.

Initial contact was made by sending an email to potential participants with a description of the study and an invitation to participate. Each participant was randomly assigned into one of the three experimental conditions for this study. This email contained a link to the study. If the link was clicked, the individual was forwarded to a page that overviewed the study and provided assurance that all answers were anonymous but would be used for research at the aggregate level. After consenting to participate, participants were forwarded to the study, which was completed entirely online, and were randomly assigned into one of the three experimental groups outlined in Table 1. This online format allowed the researcher to record the length of time each participant took to complete the task. Overall, participants spent an average of 21 minutes on the task, with a range five minutes (minimum) to 54 minutes (maximum).

Over 10% of the individuals responding to the study contacted the researcher by email or telephone after completing the task, which allowed the researcher to further understand the decision processes of lawyers presented with this scenario and confirm that the scenario was understood and realistic. Although some issues with the case were identified by these parties that could be the subject of future research (i.e., differing state laws, influence of bankruptcy judges), no clear issues emerged that would likely influence the results of the study. Overall, the majority of these individuals indicated that they found the study interesting, and were motivated to initiate direct contact with the researcher to request a copy of the study results. This direct feedback from participants provided additional assurance that the case was externally valid, and that appropriate questions were asked in the task.

Participants

The population for this study was identified as lawyers specializing in business law, bankruptcies, and/or securities litigation. These individuals are most likely to be in the position of deciding whether to pursue litigation against auditors or providing legal advice to individuals or organizations seeking recovery of losses from auditors (Mong and Roebuck, 2005). To obtain a representative sample from this population, lawyers were identified using practice area segmented lists of lawyers located on the American Bar Association website (www.abanet.org) and the National Association of Bankruptcy Trustees website (www.nabt.com).

Approximately 3,216⁶ email invitations were sent to lawyers for the final data collection phase. Out of this mailing, 212 unique entries to the online instrument were recorded (response rate of 6.5%). 119 of these individuals completed the task (dropout rate of 43.8%, response rate of 3.7%). A total of 19 individuals did not pass the manipulation check question, ‘What did the independent auditors of Clovitech, Inc. conclude in their report on internal controls for the 2007 financial statements?’ These individuals were not included in the sample for analysis. Therefore, 100 responses were usable out of this sample (useable response rate of 3.1%). The researcher communicated with multiple individuals who did not complete the study by email and/or telephone. Many of these individuals, although listed as specialists in securities law and/or business law on the ABA website, indicated that they did not feel professionally qualified to answer the questionnaire. Also, four emails were received in the weeks following the end of the data collection period indicating that the individuals did not complete the task because they were out of town during the study period. Finally, although the researcher was able to track and note

⁶ The population size may not be exact, as the study was conducted by sending emails to potential participants, and the emails may not have reached the intended destination.

any emails that immediately bounced back, the large amount of emails sent for this study are susceptible to being labeled as junk email and may not have reached many of the potential participants. Consideration of these factors may partially explain why low overall response rates occurred in this study.

To test for non-response bias, responses and demographic characteristics from individuals completing the study at the end of the allotted time period were compared to responses received at the beginning of the allotted time period. No significant differences were found, indicating that non-response bias should not be an issue with the results of this study. After accounting for individuals that did not pass the manipulation check, the final sample size for the study was 100 participants, with 33 responses in the ‘Unqualified/No Disclosure’ condition, 30 responses in the ‘Unqualified/Disclosure’ condition and 37 responses for the ‘Adverse’ condition.

Overall, the participants were an average of 54 years of age, and 91.8% of the respondents were male. All participants in the sample indicated that they either were currently practicing lawyers or recently retired. All of the participants indicated that they had a graduate degree in law, with 22.2% indicating that they also completed a major or minor degree in a business-related field. On average participants indicated that they spend over 50% of their time working on civil cases, and all participants indicated that they were specialists in at least one area that would likely qualify them as experts in the type of case presented in this study (i.e., Securities Law or Business Law). In addition, over 50% of the sample have been professionally involved in cases where the auditor was implicated for damages. Overall, the participants indicated that they have a high level of knowledge and experience in the type of scenario

presented in the case for this study, and were qualified to make the types of decisions asked of them in the questionnaire.

A detailed analysis of the demographic characteristics of this sample, categorized by experimental condition, is shown in Table 2 and 3 in Appendix A. T-tests of these items reveal no statistically significant differences across conditions in the demographic characteristics of the individual participants. Demographic variables were also entered as covariates in the analyses described in the results below to test whether the demographic characteristics of the participants significantly influenced the dependent variables in this study. No significant covariates were identified in this analysis.

Measurement of Variables

The main independent variable of interest in this study ('404 Report') was manipulated between-subjects by randomly assigning lawyers into groups, and presenting each group with one of the three scenarios. The three scenarios are as follows: (1) unqualified with no additional disclosures (identified in the study as 'Unqualified/No Disclosure' or 'Group 1'), (2) unqualified with additional disclosures of significant deficiencies (identified in the study as 'Unqualified/Disclosure' or 'Group 2'), or (3) adverse (identified in the study as 'Adverse' or 'Group 3').

The main dependent variable in this study, 'Auditor Litigation Exposure', was measured with three questions. Participants were first asked for the percentage likelihood, from 0-100%, that the auditor in the scenario presented would be sued by stockholders. Then, the participants were asked to rate the strength of the potential case against the auditor on a scale from one (extremely weak case) to seven (extremely strong case). Last, the participants were asked to

express their level of agreement on a scale from one (completely disagree) to seven (completely agree) with the statement ‘I would advise stockholders to file a lawsuit against the auditors’. The measures in this study each represent an underlying variable that is continuous, and will be treated as continuous variables for analysis purposes.

Results

Descriptive Statistics

The first hypothesis in the study examines whether voluntary disclosures within an unqualified Section 404 report will generate more favorable evaluations of the auditor when compared to unqualified opinions without such a disclosure. The second hypothesis examines whether auditors are viewed more favorably when they report an adverse opinion on internal controls, compared to when they report an unqualified opinion with or without voluntary disclosures. Each of these hypotheses are first tested by conducting a multiple analysis of variance (MANOVA), followed by an individual analysis of the influence of the Section 404 reporting conditions on each of the three different measures of auditor litigation exposure (% likelihood of being sued, strength of the case against the auditor, and advice to file/not file a lawsuit against the auditor). Table 4 provides an overall summary of the responses to these three measures for each of the three Section 404 reporting conditions examined in the study.

Descriptive statistics indicate that when auditors reported an unqualified opinion with no disclosure of internal control deficiencies, the mean response from lawyers was 84.8% when asked to evaluate the likelihood of the auditor being sued, compared to the ‘Unqualified/Disclosure’ group mean of 88.2%, and ‘Adverse’ group mean of 74.1%. The mean response for this question overall was 81.9%, which is a strong indicator that the auditor would

be sued across all scenarios. When asked to evaluate the strength of the case against the auditor on a scale from one (extremely weak case) to seven (extremely strong case), the ‘Unqualified/No Disclosure’ group responded with a mean of 5.636, the ‘Unqualified/Disclosure’ group mean was 5.333, and the ‘Adverse’ group mean was 4.703. The overall mean for all participants in response to this question was 5.200 (between slightly strong case and somewhat strong case). When asked if they would recommend filing a lawsuit against the auditor, the ‘Unqualified/No Disclosure’ group responded with a mean of 6.091 on a scale from one (completely disagree) to seven (completely agree), compared to a mean of 6.100 for the ‘Unqualified/Disclosure’ group, and 5.000 for the ‘Adverse’ group. The mean response overall to this question was 5.690 (between slightly agree and somewhat agree), indicating that the participants were generally inclined to recommend that the auditors be sued by stockholders to recover losses.

H1: Unqualified without Disclosure vs. Unqualified with Voluntary Disclosure

To test H1, a MANOVA was performed to examine the impact of the independent variable ‘404 Report’ on the dependent variable ‘Auditor Litigation Exposure’⁷. The variable ‘404 Report’ for H1 represents two different conditions in which the auditor provided either an unqualified opinion on internal controls with no disclosure (‘Unqualified/No Disclosure’) or an unqualified opinion on internal controls with a voluntary disclosure (‘Unqualified/Disclosure’). The dependent variable was measured by the lawyers’ perception of the likelihood that the auditor would be sued, their opinion on the strength of the case against the auditor, and their recommendation to shareholders on whether to sue the auditor to recover damages. As shown in Table 5 Panel 1A, MANOVA results indicate no significant effect for the independent variable

⁷ Although descriptive statistics suggest that the normality assumption may be violated, MANOVA was considered appropriate. Research suggests that MANOVA tests are insensitive to normality violations (Keselman et al., 1998).

‘404 Report’, Wilks lambda= 0.941, $F(1,61) = 1.244$, $p=0.151$ (one-tailed). The partial Eta squared was 0.059, which means that the independent variable accounted for 5.9% of the variance in the dependent variable. Table 5 Panel 1B also shows the univariate analysis of the variance (ANOVA) results for each individual measure of ‘Auditor Litigation Exposure’. The ANOVAs provide similar results, with no significant effects indicated for the likelihood of auditors being sued, $F(1,61)=0.376$, $p=0.271$ (one-tailed), the strength of the case against the auditor, $F(1,61)=0.602$, $p=0.221$ (one-tailed), or the recommendation to sue the auditor, $F(1,61)=0.001$, $p=0.490$ (one-tailed).

Overall, these results fail to support H1, finding no difference in lawyers’ evaluations of auditor litigation exposure when auditors provide either an unqualified opinion on internal controls without disclosures of internal control deficiencies or an unqualified opinion on internal controls with voluntarily disclosure of deficiencies. These results appear to indicate that providing voluntary disclosure within a Section 404 report does not reduce the likelihood of being sued in the event of an audit failure. Potential implications of these results are further discussed in the Conclusion section below.

H2: Adverse Opinion on Internal Controls

H2 predicted that auditors providing an adverse opinion on internal controls would be evaluated more favorably by litigators than auditors providing an unqualified opinion on internal controls, with or without disclosures of significant deficiencies. The analysis for H2 differs from H1 with the addition of a third group for the independent variable ‘404 Report’, representing participants in the ‘Adverse’ Section 404 report condition. Dependent variable measures for ‘Auditor Litigation Exposure’ are the same as in the above analysis for H1, with participants

responding to three questions assessing the likelihood of the auditor being sued, the strength of the case against the auditor, and agreement with a recommendation to sue the auditor.

As shown in Table 5 Panel 2A, MANOVA results for H2 indicate a significant effect for the independent variable '404 Report', Wilks lambda= 0.868, $F(2,97) = 2.319$, $p=.035$ (two-tailed), indicating that the auditor's report on internal controls influenced lawyers' perceptions of their litigation exposure, as represented by all three dependent variable measures. The partial Eta squared was 0.068, which means that the independent variable accounted for 6.8% of the variance in the dependent variable. ANOVAs were also performed for each of the three individual dependent variable measures to further understand how the auditor's Section 404 report influences lawyers' evaluations of auditor litigation exposure.

Table 5 Panel 2B provides the results for the separate ANOVAs on the three different dependent variables. An ANOVA of the participants' responses to the likelihood (from 0-100%) that auditors would be sued indicate marginally significant differences in the dependent variable between Section 404 reporting conditions, $F(2,97)=3.021$, $p=0.053$ (two-tailed). Using pairwise comparison of the means, the 'Adverse' group (mean of 74.1%) evaluated auditors more favorably when compared to both the 'Unqualified/No Disclosure' (mean of 84.8%), $p=0.073$ (two-tailed), and 'Unqualified/Disclosure' groups (mean of 88.2%), $p=0.023$ (two-tailed). This result provides support for H2, which predicted that auditors reporting an adverse opinion on internal controls would be evaluated more favorably than auditors who reported an unqualified opinion on internal controls, with or without a voluntary disclosure.

An ANOVA of the participants' assessment of the strength of the potential case against the auditors (on a scale from one (extremely weak case) to seven (extremely strong case)) indicated significant differences in the dependent variable between Section 404 reporting

conditions, $F(2,97)=3.253$, $p=0.043$ (two-tailed). The ANOVA results also report significant differences in a pairwise comparison of the means of the strength of the case against the auditor between the 'Adverse' group (mean of 4.702 on a scale from one to seven) and the 'Unqualified/No Disclosure' group (mean of 5.636) at $p=0.015$, and marginally significant differences between the 'Adverse' group and the 'Unqualified/Disclosure' group (mean of 5.333) at $p=0.100$. Overall, the 'Adverse' group's mean responses were lower in comparison to both other groups, meaning that participants in this group assessed the case against the auditors to be weaker when the auditor's Section 404 report communicates an adverse opinion on internal controls.

An ANOVA of the participants' assessment of their agreement with the statement that they would advise shareholders to sue the auditor (on a scale from one (strongly disagree) to seven (strongly agree)) indicated highly significant differences in the dependent variable between Section 404 reporting conditions, $F(2,97)=5.394$, $p=0.006$ (two-tailed). The ANOVA results also report significant differences in a pairwise comparison of the means of responses to this measure between the 'Adverse' group (mean of 5.000 on a scale from one to seven) and the 'Unqualified/No Disclosure' group (mean of 6.090) at $p=0.006$ and the 'Unqualified/Disclosure' group (mean of 6.100) at $p=0.007$. The groups receiving a scenario with an unqualified opinion (with or without disclosures) reported means significantly higher than the mean of the 'Adverse' group, meaning that participants in the 'Adverse' group were less likely to recommend that the stockholders sue the auditor in comparison to the other groups.

Review of the above results consistently support differences between the 'Adverse' group and the 'Unqualified/No Disclosure' and 'Unqualified/Disclosure' groups, indicating that H2 is supported. However, no significant differences were found between the 'Unqualified/No

Disclosure’ and ‘Unqualified/Disclosure’ groups, indicating that H1 is not supported. Therefore, results suggest auditors litigation exposure will decrease by providing an adverse opinion on internal controls, but not through voluntary disclosures in an unqualified opinion on internal controls.

Additional Analysis: Litigation Exposure of Other Parties

Although the main purpose of this study is to examine how auditors are perceived by potential litigators, other parties involved in the financial reporting process may also be implicated in the event that shareholders experience a significant financial loss of investment. Although the auditor’s Section 404 reporting decisions are not decided upon directly by top management and the audit committee, these parties are actively involved in financial reporting decisions and have significant influence over the audit process. Therefore, an additional six questions were asked to assess the litigation exposure of the top managers and the audit committee members of the failed company (three questions for each potentially liable party). Initially, these questions were asked in order to decrease the potential demand effect of asking participants only to consider the auditor as a source for stockholders to recover their losses, and to increase the external validity of the task. However, answers to these questions could provide interesting insights on how auditor reporting decisions can influence the litigation exposure of other parties.

To measure the dependent variables ‘Top Management Litigation Exposure’ and ‘Audit Committee Litigation Exposure’ participants were asked to respond to a series of three questions concerning both management and the audit committee. First, participants were asked to provide their assessment of the percent likelihood that the managers (audit committee) would be sued (0-

100%). Participants were also asked to provide their opinion on the strength of the potential case against the managers (audit committee) on a scale from one (extremely weak case) to seven (extremely strong case). Finally, the participants were asked to rate their level of agreement, on a scale from one (completely disagree) to seven (completely agree), with the statement ‘I would advise stockholders to file a lawsuit against the managers (audit committee).’

Top Management Litigation Exposure

Management has the primary role of maintaining effective internal controls and reporting on their effectiveness. They also provide auditors with much of the information that they need to formulate the auditor’s opinion on internal controls reported in the Section 404 report. Therefore, in the event that stakeholders experience significant losses, management’s litigation exposure may be influenced by the auditor’s Section 404 report.

Table 6 provides a summary of the responses relative to the likelihood of suing management. Participants first responded with their assessment of the percent likelihood that the managers would be sued (0-100%), with an average response of 86.2% overall to this question⁸. Next, participants responded with an overall mean of 5.930 when asked to assess the strength of a potential case against the managers on a scale from one (extremely weak case) to seven (extremely strong case). Finally, average responses were 6.160 overall on a scale from one (completely disagree) to seven (completely agree) when asked if they would advise suing management.

To examine the potential impact of the auditor’s Section 404 report on the litigation exposure of the top managers of the failed company, a MANOVA was performed with the

⁸ Although descriptive statistics suggest that the normality assumption may be violated, MANOVA was considered appropriate. Research suggests that MANOVA tests are insensitive to normality violations (Keselman et al. 1998).

dependent variable 'Top Management Litigation Exposure' measured as the response to questions requiring participants to assess the % likelihood of management being sued, strength of the case against management, and their advice to file/not file a lawsuit against management. As shown in Table 8 Panel 1, no significant effect was found for the independent variable '404 Report', Wilks lambda= 0.917, $F(2,97) = 1.395$, $p=0.218$ (two-tailed). Table 8 Panel 2 also shows the separate ANOVAs which were performed on each of the individual measures of litigation exposure. No significant effects were found. Overall, potential litigators' assessment of management's litigation exposure does not appear to be influenced by the auditor's Section 404 reporting decisions. As shown in Table 8 Panel 2, participants assessed managements' litigation exposure to be high across all conditions, indicating that management may be highly exposed to litigation in the event of significant stakeholder losses regardless of the auditor's Section 404 reporting decision.

Audit Committee Litigation Exposure

Audit committees are charged with the oversight of the auditing and financial reporting process, and often actively participate in discussions with the auditor and management concerning Section 404 reporting decisions. Therefore, audit committees are likely to be implicated in the event of a significant stakeholder loss, and their litigation exposure may be linked to the auditor's Section 404 reporting conclusions.

Table 7 provides a summary of the responses relative to the likelihood of suing the audit committee. Participants first responded with their assessment of the percent likelihood that the audit committee would be sued (0-100%), with an average response of 79.4% overall to this question. Next, the overall mean of participants' responses was 5.606 when asked to assess the

strength of a potential case against the audit committee on a scale from one (extremely weak case) to seven (extremely strong case). Finally, average responses were 5.253 overall on a scale from one (completely disagree) to seven (completely agree) when asked if they would advise suing the audit committee.

A MANOVA performed with the main dependent variable Audit Committee Litigation Exposure, which was measured as described in the section above. As shown in Table 9 Panel 1, the independent variable '404 Report', resulted in a marginally significant effect, Wilks lambda= 0.879, $F(2,97) = 2.093$, $p=0.056$ (two-tailed). The partial Eta squared was 0.063, which means that the independent variable accounted for 6.3% of the variance in the dependent variable. This result indicates that potential litigators' evaluation of audit committee litigation exposure is influenced by the auditor's Section 404 reporting decisions. To further examine this result, ANOVAs were performed for each of the three individual dependent variable measures.

As shown in Table 9 Panel 2, an ANOVA of the participants' responses to the likelihood (from 0-100%) that the audit committee would be sued indicated significant differences in the dependent variable between Section 404 reporting conditions, $F(2,97)=4.032$, $p=0.021$ (two-tailed). Further investigation with a pairwise comparison of the means indicated that significant differences in the dependent variable exist between the 'Unqualified/No Disclosure' group (mean of 70.0%) and the Unqualified Disclosure group (mean of 87.1%) at $p=0.007$. Further, significant differences exist between the 'Unqualified/No Disclosure' group and the 'Adverse' group (mean of 81.3%) at $p=0.057$. The 'Unqualified/No Disclosure' group mean is significantly lower in comparison to both other groups. No significant differences were indicated between the 'Unqualified/Disclosure' group and the 'Adverse' group for this measure

An ANOVA of the participants' assessment of the strength of the potential case against the audit committee (on a scale from one (extremely weak case) to seven (extremely strong case)) indicated no significant differences in the dependent variable between Section 404 reporting conditions, $F(2,97)=1.882, p=0.158$ (two-tailed). A pairwise comparison of the means of responses to this measure between all three groups indicates that there were no significant differences between the 'Unqualified/Disclosure' group (mean of 4.968), the 'Unqualified/No Disclosure' group (mean of 5.666) and the 'Adverse' group (mean of 5.162).

An ANOVA of the participants' assessment of their agreement with the statement that they would recommend that the shareholders file a lawsuit against the audit committee (on a scale from one (strongly disagree) to seven (strongly agree)) indicated marginally significant differences in the dependent variable between Section 404 reporting conditions, $F(2,97)=3.057, p=0.052$ (two-tailed). A pairwise comparison of the means of responses to this measure between the 'Unqualified/Disclosure' group (mean of 6.200) and both the 'Unqualified/No Disclosure' (mean of 5.343) and 'Adverse' (mean of 5.351) groups at $p=0.035$ and $p=0.031$ respectively.

Overall, the 'Unqualified/Disclosure' group reported significantly less favorable predictions in comparison to the 'Unqualified/No Disclosure' group for two of the measures of audit committee litigation exposure, implying that audit committee members may be exposed to more litigation under this condition. Lawyers also were more likely to recommend filing a lawsuit against the audit committee in the 'Unqualified/Disclosure' group, when compared to both other groups. This result indicates that audit committees may be more exposed to litigation when the auditor provides voluntary disclosures within an unqualified Section 404 report, compared to when an auditor provides an unqualified opinion on internal controls with no disclosures or an adverse opinion on internal controls. However, the mean results for all audit

committee litigation exposure measures are significantly lower in comparison to the results for management litigation exposure ($p=0.001$). Therefore, although the audit committee is likely to be sued, management appears to be exposed to more litigation risk. This may be due to the audit committee's lack of direct involvement in the everyday business of the company and lack of direct responsibility for establishing internal controls over financial reporting.

Conclusion

To summarize the overall findings, H1 was not supported, but H2 was supported for all measures of the dependent variable 'Auditor Litigation Exposure'. These results suggest that the auditor's report on internal controls reduces litigation exposure when the auditor communicates an adverse report on internal controls, but litigation exposure is not reduced by providing additional disclosures within an unqualified report on internal controls. These results may indicate that a voluntary disclosure of a significant deficiency in internal controls is not perceived as a strong enough signal of risk by potential litigators, and that an adverse opinion provides a stronger signal of risk to stakeholders of the potential for material misstatements in the financial statements. This finding means that auditors have the opportunity to decrease litigation exposure by providing information in the Section 404 report that signals a potential risk of material misstatements as a result of a failure in internal controls. Therefore, in the event that the auditor fails to uncover fraudulent financial reporting or material errors within the financial statements, the signal created by an adverse Section 404 report may be sufficient to decrease the likelihood that they will be sued in the future.

Another interesting result of this study is found in the examination of the audit committee and management's litigation exposure under different Section 404 reporting conditions.

Management appears to have the more litigation exposure overall, no matter what the auditor's Section 404 report concluded. This result suggests that litigators place most of the responsibility for financial reporting on management, and that management is likely to be implicated no matter what the auditor reports communicate. The audit committee appears to be exposed to greater litigation risk when the auditor reports an unqualified opinion on internal controls with voluntary disclosures of a significant deficiency. This result could suggest that litigators believe that the auditor should have reported an adverse Section 404 opinion after uncovering the issues in internal controls within the company, and that these litigators are placing blame on the audit committee for neglecting to support the auditor's findings.

Future research in this area could focus on the litigation exposure of management and the audit committee. Although management's litigation exposure was not influenced by the auditor's Section 404 reporting decisions in this study, future research could examine management and their responsibilities and disclosures related to internal controls. Since results in this study suggest that audit committee litigation exposure is influenced by the auditor's reporting decisions, future research could also explore how the decisions made by each party in the auditing and financial reporting process influences litigation risk of the auditor, audit committee, and management. For example, future research could examine whether decisions made by the audit committee influence auditor litigation exposure.

The main limitation of this study is the use of an online data collection method, which raises minor issues with the inability to control the attentiveness of the respondent to the task or to be certain of the exact calculation of response rates. This method also increases the risk of low overall response rates due to the potential that emails were not received (i.e., individual out of town, identified as junk, server timeouts, etc.). However, non-response bias does not appear to be

an issue in this study, as indicated by the lack of significant differences in the sample characteristics and responses in early vs. late completions. An additional limitation of this study is the use of summary case materials. Although the facts of the case are based on real cases, lawyers most likely would collect information differently when providing advice to shareholders and/or considering taking on a new case. However, the pre-test phase allowed for the addition of material facts as suggested by lawyers with expertise in this area, and the lawyers overall assessed the situation to be realistic. Future research conducted with lawyers as participants could be improved by contacting individuals by telephone or in person at a professional conference, which would likely address many of the limitations described above.

In conclusion, this study focused on the auditor's report on internal controls as a potential deterrent to litigation in the event of a reporting failure that is attributed to deficient internal controls. The results provide evidence that Section 404 reports are relevant to lawyers when asked to evaluate the strength of a potential case against an auditor and provide legal recommendations to shareholders seeking to recover losses. Although results do not suggest that auditors can decrease their litigation exposure by voluntarily disclosing significant deficiencies in internal controls within their Section 404 reports, results do suggest that an adverse opinion on internal controls may decrease auditor litigation risk in the event of significant shareholder losses.

Results of this study should not be interpreted as a lack of support for any potential benefits of voluntary disclosures for auditors, but do suggest that voluntary disclosures may not prevent the auditor from being sued. However, this study was limited in nature by focusing on the potential for voluntary disclosures within the Section 404 report to decrease litigation exposure, which is only one component of the auditor's overall exposure to monetary losses

related to lawsuits. Related research was conducted in a second study investigating how disclosures within Section 404 reports can represent a strong defense in a trial setting when shareholder litigation is pursued against the auditor. Since a trial setting provides opportunities for the plaintiff (representing shareholders) to argue why the auditor should be found guilty of negligence, and for the auditor's council to argue why the auditor's actions were appropriate given their knowledge at the time, the second study more directly addresses how individuals perceive the signals provided by Section 404 reports. This second study focuses on juror decisions, which can provide insight into potential losses in the event of litigation, and further assist auditors and their legal counsel in decisions to settle or risk a trial. Overall, the combined perspective of these separate studies will provide a comprehensive understanding of how Section 404 influences auditor litigation exposure (study one) and legal liability exposure in the event of a trial (study two).

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STUDY TWO: AUDITOR LIABILITY FOR SOX SECTION 404 REPORTS: AN INVESTIGATION OF JURORS' CONSIDERATION OF AUDITOR DISCLOSURE OF INTERNAL CONTROL DEFICIENCIES

Introduction

Many of the criticisms surrounding the Sarbanes-Oxley Act of 2002 (SOX) concern the increased legal liability exposure for auditors, specifically related to the provisions under Section 404. Researchers have argued that the marked increase in audit fees following SOX are partially due to this increased risk of litigation (Asare et al., 2007; Bush et al., 2007). Since the downfall of Arthur Andersen, other large audit firms remain concerned that a highly publicized audit failure could lead to a similar detriment for any audit firm (Younglai, 2008). Motivated by this concern, the chairperson of the SEC submitted a formal request in 2007 to the senate proposing a safe harbor for auditors by limiting the awards from class action lawsuits for audit failures related to the Section 404 reporting requirements. As a result of the SEC proposal and other encouragement from the business community, a U.S. Treasury Department panel agreed to consider recommending some form of protection to auditors against lawsuits (Younglai, 2008). However, this panel was were not able to reach a consensus on whether they would recommend limitations of liability for auditors, indicating the need for more knowledge about auditor liability exposure before any final decisions could be made. In contrast, some argue that the United States courts have started a trend indicating a pro-defendant stance in recent securities suits; and, the business profession is exaggerating both the costs and the liability exposure related to Section 404 reporting (Balber, 2008).

This study experimental investigates the impact of Section 404 reporting on the legal liability exposure of auditors by examining how internal control disclosures, and the nature of the internal control in question, influence jury trial outcomes. Specifically, the purpose of this study is to examine whether voluntary disclosure of different types of significant internal control deficiencies within the Section 404 report is deemed by jurors to be a sufficient red flag that a company could have materially misstated financial statements. Although auditors do not currently report significant deficiencies in their reports on internal controls, some public companies have begun voluntarily providing details on significant deficiencies in managements' report on internal controls (Hammersley et al., 2008). Research indicates that the market reacts to such disclosures, suggesting that disclosures of significant deficiencies may be valued by investors (Hammersley et al., 2008). Past research on disclosures within audit reports suggests that auditors are evaluated more favorably when they provide a red flag of potential issues within a company, even if the disclosure is not fully accurate in its evaluation of the likelihood or significance of the issue within the company (Mong and Roebuck, 2005). Results of this study indicate that providing such a disclosure is highly beneficial when the auditor discovers a deficiency in an internal control that is more auditable, such as a transaction level control. A voluntary disclosure of this particular type of internal control provides protection to the auditor from liability in 92.0% of the responses of jury eligible participants in this study, and is the only scenario in which the auditor is not assessed punitive damages. These results provide support for increased transparency in the auditor's Section 404 report as a way for the auditor to decrease their liability exposure.

In addition, this study examines whether failure to report internal control weaknesses which are inherently more subjective and difficult to test, such as management integrity, result in

less favorable outcomes for an auditor in a jury trial. When the auditor's decisions are subjective, they must rely heavily on professional judgment, rather than tangible evidence; the auditor has a significant amount of discretion over their final judgments. When the auditor's decisions are more objective with tangible evidence to rely upon, more reliance is placed on the evidence with less reliance on professional judgment. If a decision is based on tangible evidence, the auditor exerts less professional judgment (i.e., less discretion). Although jurors should take into account the difficulty of the auditor's decisions when traditional substantive audit evidence cannot be collected to support their conclusions, past research indicates that blame is more likely to be attributed to individuals who have more discretion in their decisions (Kelley and Michela, 1980). Therefore, when required to exert a greater amount of professional judgment, the auditor may be held to a higher standard regarding legal liability, as jurors may perceive that the auditor had more control over such decisions compared to auditors who can rely on evidence. The increased reliance on professional judgment required when evaluating less auditable internal controls may expose auditors to more blame in a trial setting. Results of this study support this line of reasoning, indicating that auditors are found more liable by jurors when they failed to predict accurately the impact of a less auditable internal control, such as the control environment.

This study contributes to literature on auditor legal liability by providing insight into jurors' perceptions of auditors in the post-SOX disclosure environment, specifically indicating how internal control disclosures impact legal liability exposure. In addition, the paper contributes to the previous literature regarding juror decision-making by providing insight into jurors' perceptions of Sarbanes-Oxley disclosures. Past behavioral research on auditor liability has consisted of scenarios in which the outcome of the financial audit and resulting audit opinion led to a lawsuit alleging negligence. Overall, the context of past research has focused on the

litigation outcomes when the auditor fails to *detect* fraud or material misstatement. In contrast, this paper focuses on auditor liability where the auditor not only fails to detect a misstatement but also fails to disclose weaknesses in internal controls that are in place to *prevent* fraud or material misstatement. This scenario is unique to this literature, as the audit opinion on internal controls has been argued to be more ambiguous and rely more heavily on professional judgment than financial audit decisions. Even when faced with a known deficiency in internal controls, the auditor must make a judgment on the likelihood of the deficiency to fail to prevent or detect a material misstatement, which is at times highly subjective in nature (Hammersley et al., 2008). Therefore, this study examines jurors' decisions in a situation when the auditor's relies heavily upon professional judgment.

This study provides insights that are informative to auditors, lawyers, and regulators. Auditors can utilize the results of this study to make reporting decisions, and auditors and their legal counsel may consider the results of the study to make decisions to either settle or risk a jury trial when they are sued for negligence. In addition, specific characteristics of the participants in this study were examined for their impact on decisions made in a trial setting, which could be useful for strategic jury selection. Regulators may find the results of this study informative when considering the possibility of legal liability caps or other limitations on awards in jury trials involving auditors or other professionals. Since jurors in this study evaluated auditors less favorably in situations involving Section 404 report disclosures that are considered more ambiguous and less auditable, regulators may wish to consider providing additional protection to auditors for such disclosures.

The following sections will examine the different factors related to provisions of Section 404 that could potentially impact the liability exposure of accountants. The next section will

provide a summary of the changes in the profession following SOX implementation, as indicated by the wide body of accounting research. This section also will include a discussion of how the legal environment for accountants has changed because of such legislation, and address how jury trials may undermine the benefits of increased audit efforts by exposing auditors to unnecessary liability exposure and increasing costs to all. Hypotheses will then be developed to predict how Section 404 report disclosures and the subjectivity of evaluating internal control weaknesses impacts jurors' decisions in a trial scenario. Following this hypothesis development is a summary of the methodology that was used to examine whether new requirements of the Sarbanes-Oxley Act provide additional legal liability exposure, and how SOX disclosures could potentially influence decisions of jury members. The final sections will discuss the results and overall implications of this study.

Theory and Hypotheses Development

Section 404 of SOX and the U.S. Legal System

SOX has been hailed as the most important legislation in the accounting profession since the 1930's (Li et al., 2008). This legislation has been praised as being "one of the greatest protections in history for the public interest in the arena of the financial markets and related corporate behavior (Canada et al., 2007, p. 1). Although many of the changes implemented as a result of SOX have had a significant impact on the accounting industry, Section 404 has perhaps received the most attention from both practitioners and researchers. Section 404 has extended auditors' responsibilities by requiring an integrated audit that results in a separate *audit opinion on internal controls*. This section alone has motivated a tremendous body of research on the

aftermath of SOX, which highlights both positive and negative aspects of the legislation (Boyle and Webb, 2007).

Many of the positive aspects of Section 404 relate to the potential for higher quality audits as well as improvements in the quality of financial reporting. Research in the post-SOX era contains evidence of some improvements in fraud detection (Dyck et al., 2008), an increase in voluntary disclosures (Gordon et al., 2006), and a decrease in earnings management behavior (Cohen et al., 2008). In addition, researchers have found that capital markets respond differently to different types of internal control weakness disclosures (Hammersley et al., 2008). Therefore, the information contained within SOX reports appears to be informative based on the type of weakness identified. Other studies criticize the increased costs of Section 404, and note many downsides to implementing the increased internal control requirements. One of the primary outcomes from this line of research is the increased cost associated with implementing the requirements of SOX. This has been a particularly critical issue relative to smaller companies, as they may not be able to withstand the burden caused by these increased costs (DeFond and Francis, 2005; Solomon, 2005; Arnold et al., 2007).

Although the success or failure of Section 404 in improving the reliability of financial reporting is much debated, as are the costs and benefits, the reality of the matter is that regulators have stood their ground in requiring compliance for auditors and most corporations (Henry and Borrus, 2006). Section 404 required a significant increase in the level of assurance provided by the auditor's reports, by assuring not only *detection* of fraud, illegal acts, and misstatement of the financial statements, but a separate opinion assuring that adequate internal controls are in place for the *prevention* of fraud (Cunningham, 2004). This opinion on internal controls is a new requirement to be performed as part of an integrated audit of internal controls and financial

statements for public companies. In the past, internal control evaluations were primarily used for audit planning purposes, so this new requirement significantly increased the importance of an auditor's evaluation of internal controls (Asare et al., 2007). Therefore, this new requirement expanded the attention given to internal controls during an audit and increased the auditor's responsibility by requiring a separate opinion devoted entirely to their assessment of internal controls.

Since internal control evaluations are inherently subjective and complex in nature, auditors must often rely on professional judgment to assess materiality and may not be able to perform audit procedures to audit around certain controls (McConnell et al., 2003; Paul, 2005). In the *audit opinion on internal controls*, auditors "must describe material weaknesses, their actual and potential effects on financial statements and related control objectives, and their effects on the auditor's financial statement audit (Cunningham, 2004). In the event of a failure of internal controls leading to significant losses, auditors are not only exposed to potential liability for negligence, but also to a more serious charge of misleading investors related to this required disclosure (Cunningham, 2004). SOX, in its current form, provides no additional protection to auditors from litigation, which leaves auditors vulnerable to a new type of lawsuits related to internal control reporting. Therefore, some have attributed increased audit fees and legal costs to companies to this lack of liability protection (Cunningham, 2004; Younglai, 2008).

The increase in audit fees following SOX has often been attributed to a rise in liability exposure for the auditors. Preliminary evidence supports this assumption by indicating that the amount of corporate litigation attributed to internal control failures has increased significantly following SOX (Paul, 2005; Lamont and Etzold, 2007). Many audit firms have chosen to settle out of court, making archival research on the topic difficult, if not impossible, to conduct.

Accordingly, jury trials related to audit failures following SOX have been rare, as audit firms have argued jury trials present an exaggerated risk of significant losses in money or reputation due to biased jurors. Since auditors are already open to the threat of PCAOB enforcement actions and criminal liability under SEC regulation, their argument is that additional civil liability exposure is not only unfair, but unnecessarily raises costs across the board. Auditors have expressed concern that they are placed in the position of paying out-of-pocket for every civil suit brought against them to prevent a jury trial, even when they believe that they have a strong defense.

Although the inclusion of an additional audit opinion on internal controls has been criticized for the additional costs and liability exposure associated with the new internal control reporting requirements, many argue that the Section 404 report provides important information for decision makers. Section 404 requires auditors to perform an integrated audit of internal controls and the financial statements, and express a separate opinion on internal controls in addition to their opinion on the financial statements (Asare et al., 2007). Auditors must also identify and evaluate any deficiencies they find in internal controls based on the likelihood and materiality of misstatements due to such deficiencies. Asare et al. (2007) summarize the process for evaluating those deficiencies, which is presented in Table 10. If the auditor decides that the deficiencies in internal controls are not likely to result in material misstatement of the financials, then the auditor can issue an unqualified report on internal controls. The auditor is only required to describe any deficiencies deemed material in their report, and is not required to mention any control deficiencies or significant deficiencies (PCAOB, 2007). In the case of a material weakness in internal controls, the auditor may issue an adverse opinion on internal controls and consider whether the weakness is material enough to warrant a modification of the auditor's

opinion on the financial statements (Asare et al., 2007). Although some clarifications and implementation guidance have been released to assist auditors in evaluating internal control deficiencies, the decisions involved with Section 404 reporting are considered highly complex; the auditor must rely on professional judgment more so than in the past, when internal control evaluations were primarily used for planning decisions (Asare et al., 2007).

Although Section 404 only applies to public companies, the AICPA currently requires auditors of non-public companies to perform an audit of internal controls (AICPA, 2006). One main difference between requirements under Section 404 and SAS 112 is that the AICPA requires significant deficiencies to be reported in addition to material weaknesses (AICPA, 2006). Therefore, audit reports compiled under SAS 112 are more detailed in nature and provide additional disclosures in comparison to the Section 404 report. While auditors of public companies are not currently required to disclose significant deficiencies (PCAOB, 2007), they are also not explicitly restricted from providing such disclosures. Past research indicates that increased disclosures within audit reports may inhibit legal liability exposure for auditors (Mong and Roebuck, 2005). Therefore, providing additional disclosures of significant deficiencies within the audit report may provide auditors with additional protection from liability. This additional disclosure within Section 404 reports could emerge without regulatory or standard changes as a voluntary disclosure by auditors, similar to how management of public companies have voluntarily disclosed significant deficiencies in their annual and quarterly reports on internal controls (Hammersley et al., 2008). Disclosure of significant deficiencies could also be considered as a future change in PCAOB standards that would explicitly require auditors to consider disclosing significant deficiencies that they deem important enough to communicate to the public, similar to the standard of providing an emphasis of a matter paragraph in the auditor's

report on financial statements. However, some may be opposed to this practice, suggesting that any additional disclosure from the auditor increases their liability exposure (Cunningham, 2004). Auditor's clients may also be opposed to any additional disclosures within the auditor's report on internal controls, which could discourage auditors from providing such disclosures. Further discussion of this argument is provided in the section below.

Attribution Theory and the Auditability of Control Deficiencies

Research on juror bias has often used attribution theory to explain how jurors and judges construct their decisions (Arrington et al., 1985). This theory suggests that there are antecedents and consequences to attributions (Kelley and Michela, 1980). Antecedents are circumstances or specific elements that tend to influence an individual's perception of another person's control over their decision, referred to as the *locus of control* (Kelley and Michela, 1980). An internal locus of control implies that the individual has control over his/her decisions and is responsible for any outcomes associated with the action. An external locus of control implies that the decision is more constrained or influenced by outside factors; therefore, external factors are more at fault than the individual (Kelley and Michela, 1980).

According to attribution theory, this judgment of internal vs. external control has an impact on the outcome/consequence decision within a trial setting (Kelley and Michela, 1980). This particular aspect of attribution theory may have significant implications when auditors are defendants in a court case, since the different decisions made by auditors are based on varying degrees of reliable evidence and guidance. Although all audit tasks require some level of professional judgment, some of the tasks completed by auditors allow for the collection of reliable and sufficient objective evidence to rely upon (i.e., assessing controls over a particular

transaction). In contrast, other tasks completed by auditors may not allow for the collection of traditional audit evidence, and require the auditor to rely heavily on professional judgment (i.e., assessing management's integrity). Based on attribution theory, jurors may judge the auditor's responsibility for an inaccurate judgment based on how much control the auditor had over their final opinions. When auditors have little reliable evidence available to collect (i.e., assessing management's integrity), the auditor must rely upon their own professional judgment to make decisions. This type of situation would imply an internal locus of control. In contrast, when auditors are able to collect reliable evidence, their judgments rely on external sources (reliant on the evidence). Although the auditor can arguably control how much evidence they collect, their final decision is based on the actual evidence and professional guidance, and is not as reliant on their professional judgment. In this scenario, the auditor may arguably have less individual control over the outcome of their actual decision (external locus of control), compared to the decisions made by auditors in more subjective situations.

This distinction between auditors' highly subjective judgments (implied internal locus of control) and judgments auditors make based on sufficient evidence (implied external locus of control) is important to understanding how auditors will be judged in a trial setting. Jurors tend to place more blame on individuals when they believe decisions were made based on internal motivations (internal locus of control), and tend to blame external sources when they believe the decisions were made based on external motivations (external locus of control) (Kelley and Michela, 1980). Therefore, when the auditor relies heavily on their professional judgment, they may take on much of the responsibility for their decision. When the auditor can cite objective evidence obtained during the audit as the motivation for their decision, the blame may be placed elsewhere. Past research supports this theory and indicates that when jurors believe auditors are

more in control over their judgment in question auditors are perceived more negatively than when jurors believe auditors are operating within constraints (Becker et al., 2007). Therefore, because of the highly subjective nature of the process by which an auditor reaches some of the conclusions related to the audit opinion on internal controls, attribution theory suggests that auditors may be exposed to significant liability in the event of a jury trial.

Although all of the decisions that auditors make during an audit rely to some degree on professional judgment, some decision tasks are particularly subjective. Past research has shown that internal control deficiencies can be classified into different categories based on their characteristics. One classification system that captures the subjectivity of the auditor's decision task is the division between more auditable and less auditable internal controls (Hammersley et al., 2008; Doss, 2004). Less auditable controls are those that are not as easy to audit around by performing additional audit procedures, such as those related to the control environment or weaknesses in management's integrity. In contrast, controls that are more auditable can be audited using basic audit procedures, such as closing procedures and transaction-based controls.

As discussed in the sections above, attribution theory and past research indicates that when jurors believe the auditor's decisions were based significantly on professional judgment, auditors are perceived more negatively than when jurors believe the auditor was operating within constraints (Becker et al., 2007). Less auditable controls, in comparison to more auditable controls, are arguably more reliant on the auditor's professional judgment for materiality assessments. In a litigation setting, arguments concerning their assessment of more auditable controls allow the auditor to direct the juror to evidence that the auditor collected and relied upon to make their decision, and can often provide support that other auditors would likely make similar decisions given the same evidence. In contrast, when the situation concerns less auditable

controls, the auditor does not have as much evidence to provide to explain their decisions, and some variability may exist in the types of decisions that different auditors would make in the same situation. Therefore, the auditor's decisions concerning less auditable controls will likely be perceived as heavily based on the auditor's discretion. Theory suggests that jurors will be more likely to attribute blame to the auditor under this condition (Kelley and Michela, 1980), and judge auditors harshly for failures related to these types of assessments. Therefore, the following is predicted:

H₁: In a litigation setting, jurors will evaluate auditors more favorably when an audit failure is due to a more auditable internal control weakness than when an audit failure is due to a less auditable internal control weakness.

Section 404 Reporting, Disclosures of Control Deficiencies, and Signaling Theory

The objections from the profession related to excessive liability exposure costs have led the U.S. Treasury Committee to consider placing certain limitations on how auditor liability is evaluated (Younglai, 2008). Currently, auditors are open to civil liability which mainly comes in the form of securities fraud class action suits, and are most often classified as secondary actors (Cunningham, 2004). In these cases, plaintiffs argue that the auditor was negligent and failed to perform an adequate audit to support their opinion. In most circumstances, to be found guilty of negligence, auditors must be shown to have breached a duty of care and the third party must prove that their losses are a direct result of this violation (Cunningham, 2004). Now that auditors are required to provide a separate opinion on internal controls, some suggest that auditors may become primary actors under statutory law; specifically, Section 10b-5 of the Securities Exchange Act of 1933, which exposes auditors to liability for false and misleading statements because they are explicitly providing an opinion on internal controls (Asare et al., 2007).

Many believe that the increased liability exposure for auditors is a positive side effect of SOX. The general argument from this perspective is that this increased litigation risk motivates auditors to increase quality and effort; thus, the benefits outweigh the additional costs (Krishnan et al., 2008). However, auditors argue that the legal system is biased. Past research examining juror decision-making related to auditor liability has found that jurors exhibit an outcome bias in favor of the plaintiff, whereby the fact that jurors are aware of an outcome impairs their ability to judge the auditor's performance on a past audit (Olgoff, 2003; Lipe, 2008). Bias has also been attributed to a phenomenon known as the expectation gap, which refers to the difference between jurors' expectations of the auditor and the auditor's perception of their responsibility (Koh and Woo, 1998; Lowe et al., 2002). Although Byington and Sutton (1991) argue that legal liability is the only way the public interest can influence a shift in the expectations gap from auditors' self-regulatory position of limited expectations to the public desired higher expectations, others deem this additional liability exposure as excessive to the detriment of a quality audit (Cunningham, 2004). Some have proposed ways to mitigate this bias, such as specifically addressing and discrediting the negative bias during the trial (Kadous, 2001), or drawing attention to the likelihood of an audit failure in a specific situation (Peecher and Piercey, 2008). Others suggest that specific actions taken by the auditor, such as disclosures within the audit report, can potentially decrease the auditor's exposure to litigation (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). This argument is based on the idea that auditors may be able to provide signals to stakeholders of risks within the company without having to report an adverse audit opinion, and that these signals may reduce their litigation exposure. The theory guiding this argument is commonly referred to as signaling theory.

Signaling theory suggests that when information asymmetry exists, individuals with proprietary information can provide valuable signals to the other parties that do not have access to such information. This exchange of signals is important, since information provided by signals can be communicated to parties that are otherwise relying on an incomplete set of knowledge to make decisions. However, signaling theory suggests that not all information exchanged between parties is deemed reliable by the receiving party and that only some signals will effectively reduce information asymmetry. Past studies have shown that the perceived cost of providing information is often positively related to individuals trust in the information (Titman and Trueman, 1986; Bagnoli and Watts, 2005; Levine and Hughes, 2005). This finding explains why information that is often costly to provide, such as auditor's opinions, would be demanded by individuals who do not have direct access to adequate information for decision-making.

Overall, signaling theory suggests that Section 404 disclosures may provide a way for auditors to reduce the information asymmetry that exists between a company and stakeholders (Healy and Palepu, 2001). From the perspective of signaling theory, the costliness of Section 404 reporting suggests that stakeholders will perceive the information provided by the auditor's report on internal controls as high quality. Since research suggests that perceptions of the quality of disclosures may influence how users perceive the company and impact how much influence the information has on their decisions (Latham and Linville, 1998), Section 404 report disclosures should be valuable for stakeholder decision-making. Research provides some support for this aspect of signaling theory, with evidence that stakeholders such as loan officers and investors respond to the information provided within the Section 404 report (Schneider and Church, 2008; Hammersley et al., 2008). This research suggests that, although Section 404

reporting is costly to the company, the information provides a useful signal to both investors and creditors.

Some argue that the auditor's opinion on internal controls serves as assurance that the company has controls in place that *prevent* material misstatement from occurring (Cunningham, 2004); and, in the event of an audit failure, the auditor's report on internal controls could be used against the auditor to argue that the auditor misled investors (Cunningham, 2004). However, research indicates that increased disclosures in financial audit reports, particularly in the form of an emphasis of a matter paragraph or a going concern opinion, may act as a red flag for users; and, such disclosures may decrease the likelihood of future litigation (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). Similarly, the Section 404 report may provide an additional opportunity for auditors to provide important information to stakeholders, and allow the auditors to signal risk within a company without having to modify their audit opinions. Although auditors of public companies are not currently required to report significant deficiencies discovered during an audit in their Section 404 report (PCAOB, 2007), current standards do not prevent auditors of public companies from voluntarily reporting significant deficiencies in their report.

This study proposes that such a disclosure could be framed similarly to the emphasis of a matter paragraph examined in past studies (Carcello and Palmrose, 1994; Mong and Roebuck, 2005). Such a practice would be more in line with the AICPA's requirements for reporting on internal controls for non-public companies, which are more comprehensive and require that auditors must identify and describe both material weaknesses and significant deficiencies (AICPA, 2006). Therefore, even when auditors only identify significant deficiencies (a control deficiency that has a more than remote likelihood of not preventing or detecting misstatement that may not be material), which leads to an unqualified opinion on internal controls, the auditor

could include a description of these deficiencies within the unqualified report. Signaling theory suggests that this information may be perceived as valuable for stakeholders. This disclosure could be perceived as a red flag signal of potential misstatements (Mong and Roebuck, 2005), and may either decrease the likelihood of future litigation or provide a solid argument for auditors in court that they went above and beyond the necessary reporting requirements by voluntarily reporting control deficiencies that were not deemed material weaknesses. If jurors perceive voluntary disclosures of significant deficiencies to be an adequate red flag for trouble in the company, they may be less inclined to blame the auditor in the event of a failure related to internal controls. Therefore, if the auditors are sued and the case is presented before a jury, jurors may acknowledge the auditor's increased reporting efforts and be more lenient on the auditor in assessing responsibility for losses.

H₂: In a litigation setting, jurors will evaluate auditors who report an unqualified opinion on internal controls with voluntary disclosures of significant internal control deficiencies more favorably than auditors who report an unqualified opinion on internal controls without voluntary disclosures of significant internal control deficiencies.

Research Method

A 2x2 between-subjects experiment was conducted to assess how jurors evaluate auditors in a trial setting, manipulating the disclosures contained within the auditor's unqualified opinion on internal controls (disclosure of significant deficiency vs. no disclosure of significant deficiency) and the nature of the internal control weakness that ultimately produced losses for stakeholders (less auditable vs. more auditable). Table 11 provides a detailed outline of this experimental design.

Experimental Materials and Task

Data was collected in an online setting, which allowed the researcher to record the exact amount of time spent reviewing the information and reach a broader pool of participants. Since the case was detailed and lengthy in order to preserve a realistic setting for a trial, the case was presented to the participants in both text and audio format to increase attention and control for potential differences in reading comprehension. The case was developed based on past court cases, and was examined by multiple experts in accounting and law to assure that the facts presented in the case were externally valid. The presentation structure of the case for this study was based on Kadous (2001), which provided participants with opening statements and arguments from the plaintiff and defendant, and judge instructions to the jury.

In the scenario described to the participants, the auditor reported a clean opinion on financial statements and a clean opinion on internal controls for the previous year. Then, in the following year, the company in question restated their income figures (downward) and disclosed the discovery of fraudulent activity pervasive throughout the company resulting from a material weakness in internal controls. This disclosure led to an immediate decrease in stock price and the company declared bankruptcy soon after. The facts in the case were based on past lawsuits against auditors, and were reviewed by four lawyers for accuracy and realism. The section below titled “Pre-Testing of the Case, Questionnaire, and Online Instrument” provides additional details on the pre-testing of this case.

Participants were told that the stockholders of the company decided to initiate litigation in the form of a class action suit, alleging they incurred significant losses due to auditor negligence and from relying on misleading statements from the auditor. The suit claims that their significant losses were a direct result of relying on the auditor’s disclosures when purchasing the

company's stock in the period between the release of the previous year's report and the announcements that led to the significant loss in share value. Participants were presented with a mock trial scenario with arguments from lawyers for the plaintiff (stockholders) and defendant (auditor). They were also given the option to view the auditor's report on internal controls, which was provided in PDF format. Although participants were not required to review this report, 53.5% of the individuals in the final sample indicated that they viewed the auditor's report on internal controls. There were no significant differences in decisions made by the individuals who viewed the reports and those that did not view the report, suggesting that the participants were provided sufficient information within the case to understand the auditor's Section 404 reporting decisions without viewing the report. After reviewing the case information, participants were directed to make a decision if the auditor should be liable for damages, and, if liable, determine the legal liability judgment. Appendix C shows a copy of the four cases used in this study.

Participants also answered a set of questions to gauge their understanding of the case, in order to assess whether the important details of the case (i.e., weakness type, auditor report content) were understood by the participants. In addition, participants were asked to provide answers to demographic questions and screening questions that are traditionally asked during a jury selection process. These questions relate to general characteristics such as gender and education level, and may provide insight into the participant's personal experiences that could potentially influence their decisions on such a trial. Appendix C presents a copy of the questionnaire.

Pre-Testing of the Case, Questionnaire, and Online Instrument

The case was pre-tested in multiple phases, with edits made to the case following each phase based on feedback from the pre-testers. First, the case and questionnaire were examined by four lawyers, two business law professors, and ten individuals with expertise in accounting and/or auditing. Then, the experiment was pre-tested in paper format with an additional 22 individuals who provided in-depth feedback on the understandability of the task. Finally, an anonymous online pre-test was conducted with a sample of 60 individuals. Forty-five were from a senior level auditing course, and 15 were members of the community who were eligible to serve as jurors. For this online pre-test phase, open-ended questions were asked concerning the participants' understanding of the case and questionnaire, which provided additional feedback on the communication effectiveness of the case materials.

Minor changes were made in the online case and questionnaire based on the feedback received in the online pre-test round, primarily to correct technological issues and improve clarity. For example, the online pre-test included audio of the case with a slideshow video of the text for participants to read and follow along with the audio. However, many individuals indicated that the technology for this slideshow video did not function effectively on their computer, and they were not able to read or hear the case. To accommodate for potential technology issues with the final data collection phase, the participants were instead provided with the text in an embedded text box with the ability to scroll down the page and follow along with the audio. This format allowed participants to read the text even in the event of technological issues with the audio, and delivered the text in a user-friendly format. The final instrument also included a screen that allowed participants to test the audio levels on their

computers before beginning, with detailed instructions on how to correct potential issues with their technology.

Overall, the online instrument, case, and questionnaire were greatly improved by this extensive pre-testing. Participants in the final data collection phase communicated few technological issues, and indicated that they found the task enjoyable and not overly difficult. They were asked if they experienced technological issues (91.2% responded no), if they read the text (94.0% responded yes), and if they listened to the audio (91.0% responded yes), to control for any differences that could emerge due to delivery format. As additional follow-up measures of the individuals' experiences with the task, they were asked to express their level of agreement (on a scale from one (strongly agree) to seven (strongly disagree)) with the following statements: 'The task was difficult' (mean 4.48), 'The task was enjoyable' (mean 3.03), and 'The task was realistic' (mean 2.46). The responses to this series of questions indicate that the participants on average did not find the task to be difficult, believed the task to be realistic, and enjoyed participating in the task. Follow-up questions indicated that the participants experienced issues with their own computers based on processing capabilities, or that they had to change settings on their computer to listen to the audio. However, all indicated that they were still able to either read and/or listen to the case. All follow-up questions described in this paragraph were entered as covariates in the analyses detailed in the results section to determine whether answers to the follow-up questions influenced the results of the study. T-tests were also performed to determine whether significant differences existed between conditions. Results of the covariate and t-test analyses indicate that no significant differences were found between conditions, and the individuals' responses to these questions did not influence the results of the study.

Participants and Demographic Characteristics

Emails with an embedded link to the online case and questionnaire were sent to 1,438 individuals, inviting each to participate in the study. Each potential participant was randomly assigned into one of the four manipulated conditions examined in this study. Potential participants were given two weeks to respond to the study, and reminder emails were sent within 48 hours of the closing date of the study. Overall, 242 unique entries to the survey were recorded (16.8% initial response rate). Seventy-three individuals dropped out of the task before answering any questions, and 67 individuals were excluded from the final sample for not answering the manipulation check questions accurately, failing to complete the questionnaire, or indicating non-U.S. citizenship (only U.S. citizens are eligible to serve as jurors). Nine more individuals were excluded for indicating that they have had experience as an auditor or attorney, which would most likely disqualify them from serving on a jury (Kadous 2001). After excluding these individuals, 93 useable responses were included in the final sample (6.5% usable response rate)⁹. The low response rate in this study is likely attributed to the fact that the email communicated that the task was time intensive (respondents spent an average of 36 minutes on the task), and participants were not compensated for completing the study. To test for non-response bias, the late respondents were examined in comparison to others, with no differences found. Therefore, the low response rate is not likely to result in non-response bias.

All participants in the study were identified by offering undergraduate students enrolled in business courses at a university extra credit for providing the contact information of individuals who were interested in participating in the study. The students were asked to

All tests included in this study were re-performed to include each group of excluded participants in the sample. No significant differences were found to indicate that the excluded individuals responded differently than the individuals included in the final sample.

specifically recruit people who are over 18 years of age, are not accounting students, and are currently registered to vote in the U.S. Respondents to the survey were also asked to provide email contact information for other individuals interested in participating in the study. Research indicates that responses from members of the community are similar to responses from individuals who have actually served on a jury (Bornstein, 1999), indicating that participants recruited would provide an appropriate sample for the purposes of the study.

Data was also collected on individual factors such as potential biases or background characteristics that could influence their likelihood of being selected to a jury. Individuals were not excluded from the sample based on their answers to these questions, as the jury selection is a process that is not necessarily predictable; and, different lawyers have been known to employ very different strategies when arguing which individual to exclude from the jury (Hastie 1995). Therefore, instead of automatically excluding these individuals from the main data analysis, answers to each of these questions were entered as covariates in the analyses of this study. No significant results emerged to indicate that participants' responses to this series of questions significantly influenced the results of the study.

Table 12, Panel A provides details on the demographics of the sample. Overall, the average age of the participants was 46 years, and 55.4% of the participants were female. A large majority of the sample were white (89.2%), 5.3% were Hispanic, 2.1% were African-American, and 1.0 % were Asian or Pacific Islander. Over 80% of the participants listed Florida as their state of residence and were registered to vote in this state; and, 68.8% of the participants had been called for jury duty in the past, with 29.7% of the sample having been selected to serve on the jury for a civil trial (10.7%) or a criminal trial (19.0%). These demographic characteristics are similar with the overall likelihood of an individual being called for jury duty (65.0%) and

serving on jury (37.4%), as reported in a recent nationwide Harris poll (Harris Interactive, 2008). 97.0% of the individuals indicated that they are registered to vote, with 42.1% responding that they are registered Republican, 28.4 % registered Democrat, 26.1% registered Independent, and 3.4% registered with other political parties, reported in Table 12, Panel B.

Table 13 provides details on the employment and income levels of the sample. The majority of the participants (58.1%) indicated that they were currently employed on a full-time basis. Of the remaining participants, 19.4% worked part-time, 7.5% were self-employed, 7.5% were retired, 5.4% were full-time homemakers, and 4.3% were currently unemployed. The income levels of participants were high on average, with 45.5% of the sample indicating an annual household income of over \$100K. Table 14 provides details on education level, with all participants indicating that they at least finished high school. Overall, 3.2% of the participants only graduated high school, 4.3% attended a trade or professional school, 31.2% completed some college, 29.0% graduated college, 14.0% completed some graduate school, and 18.3% of the sample completed a graduate degree in college.

Measurement and Manipulation of Variables

Manipulated Independent Variable: Type of Material Weakness

The independent variable representing the internal control weakness type, referred to as ‘MW Type’ in the sections below, was operationalized by manipulating the information provided to participants in the case scenario between groups. One condition, representing the ‘More Auditable’ internal control, tells participants that the internal controls over inventory counts and records were deficient. The second condition, representing the ‘Less Auditable’ internal control, focuses on the control environment, specifically concerning management’s overall attitude and

emphasis on meeting earnings projections at the sacrifice of financial reporting accuracy. These two scenarios are based on examples provided in the definition of auditability from previous studies (Hammersley et al., 2008; Doss, 2004).

Manipulated Independent Variable: Disclosure

The auditor's Section 404 report disclosure for the 2007 audit, referred to as 'Disclosure', was manipulated between groups with two conditions. In the first condition, the participants were told that the auditor did not publicly disclose any details about the significant deficiency in their Section 404 report. In the second condition, the auditor voluntarily provided a disclosure of the significant deficiency in their report on internal controls. In all groups, the case stated that the auditor identified the deficiency in internal controls during their audit in 2007, but assessed it to be only a significant deficiency and not a material weakness. Therefore, the audit quality remained consistent across all groups with only the disclosure of the auditor's findings differing between groups.

Dependent Variables: Measures of Auditor Liability

As shown in Appendix C, auditor liability was measured by the answers to multiple questions. First participants were asked to make the choice whether the auditor is 'Liable' or 'Not Liable' for negligent misrepresentation. Then they were asked to assess compensatory and punitive damages. Dependent variables for compensatory and punitive damages were measured by first providing a brief description of the definition of each type of damages, and then asking the individual to enter a number between \$0 and \$100,000,000 for compensatory damages and between \$0 and \$200,000,000 for punitive damages.

Participants were also asked a set of five questions, measured on a seven-point scale, which represent auditor liability exposure. These questions provided a more in-depth understanding of the participants' opinions of auditor liability. Specifically, they were asked to express their level of agreement (one indicates strongly agree and seven indicates strongly disagree) with the statements that the auditor '... is liable for negligent misrepresentation', '... performed their services in compliance within the standards that dictate how audits should be performed', '...made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose', '... could have prevented the stockholder losses' and '... is responsible for stockholder losses.'

Results

The results of the tests of the two hypotheses of this study are presented in this section. First, descriptive statistics are presented to summarize the participants' responses to the questionnaire by experimental condition. H1 is tested with the independent variable 'MW Type', which represents whether the participant was told that the audit failure is due to a more auditable internal control weakness ('More Auditable') or less auditable internal control weakness ('Less Auditable'). H2 is tested with the independent variable 'Disclosure', which represents whether the auditor provided a disclosure ('Disclosed') or did not provide a disclosure of the weakness in internal controls ('Not Disclosed'). Although not hypothesized, the interaction of these two independent variables ('MW Type' x 'Disclosure') is also analyzed to determine whether a significant interaction effect exists between the two variables examined in the study.

The dependent variable for each of the hypothesis tests is auditor liability; measured in multiple ways as described in the sections above. For each hypothesis, different tests are

performed based on how this dependent variable was measured. First, a logistic regression is performed to examine the participants' liable/not liable decisions. Then, multiple analyses of the variances (MANOVAs) are performed to understand how the participants' compensatory and punitive damage awards differ between conditions. Next an ANOVA of composite factor scores representing the ratings of the degree of auditor liability is performed to examine whether participants' responses differed between conditions. Finally, overall conclusions from these analyses are discussed to review the outcome of the hypothesis tests for this study.

Descriptive Statistics

Panel A of Table 15 provides a summary of the responses to the question 'How would you vote', with the response options 'Liable' or 'Not Liable'. A chi-square analysis of the differences between the four groups' liable/not liable judgments was significant, $\chi^2 = 12.76$, $p=0.005$. Overall, the participants in the 'Disclosed/More Auditable' condition were the least likely to find the auditor liable, with 92.0% of the sample selecting 'Not Liable'. The individuals in the 'Not Disclosed/More Auditable' condition were also more likely to find the auditor 'Not Liable' (65.0%). The majority of the individuals in the 'Disclosed/Less Auditable' condition answered 'Not Liable' (52.2%). Of the individuals in the 'Not Disclosed/Less Auditable' condition, 48.0% responded that the auditor was 'Not Liable', indicating that the majority of the individuals in this condition voted 'Liable'.

The next measures of auditor liability examined are the participants' answers to the questions 'What dollar amount in compensatory damages would you recommend be awarded to the stockholders?' (\$0 to \$100,000,000) and 'What dollar amount in punitive damages would you recommend be awarded to the stockholders?' (\$0 to \$200,000,000). Panel B of Table 15

provides a summary of the responses to these questions by experimental condition. A t-test of the differences between the four groups' was significant for both compensatory damages ($p=0.001$) and punitive damages ($p=0.008$). An overall comparison of the means again shows that individuals in the 'Disclosed/More Auditable' condition responded the most favorably for the auditor, with a mean of \$4.200 million awarded for compensatory damages and no punitive damages awarded by any individuals. The next lowest awarded damages were found in the 'Not Disclosed/More Auditable' condition, with a mean of \$16.000 million for compensatory damages and \$3.525 million for punitive damages. The 'Disclosed/Less Auditable' condition had the second highest damages awarded, with a mean of \$35.657 million for compensatory damages and \$20.283 million for punitive damages. The 'Not Disclosed/Less Auditable' condition had the highest awarded damages across all conditions, with the mean for compensatory and punitive damages equaling \$44.000 million and \$40.400 million accordingly.

Auditor liability exposure was also measured in a series of questions asking the participants to indicate their agreement (on a scale from one (strongly agree) to seven (strongly disagree)) with the questions relating to the auditor's liability, responsibility, performance quality, and disclosure quality. For analysis purposes, these questions were reverse coded so that higher numbers indicate higher liability/less favorable responses. A summary of the mean responses to these questions by condition is found in Panel C of Table 15. A multiple comparisons analysis of the mean responses by group for each of these questions indicate that the responses in the 'Disclosed/More Auditable' condition were significantly lower for four out of five of the questions, compared to mean responses from participants in each of the three other experimental conditions ($p<0.05$), indicating that the auditor was again viewed the most favorably overall in this condition. Specifically, mean responses to each question by condition

were significantly lower for the ‘Disclosed/More Auditable’ condition when responding to the questions asking whether the auditor ‘is liable for negligent misrepresentation. ‘... performed their services in compliance within the standards that dictate how audits should be performed’, ‘...made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose’, and ‘... could have prevented the stockholder losses’.

Panel D of Table 15 provides the results of a factor analysis of these measures, which indicates that all measures load effectively on one factor (all individual loadings >0.828), explaining 75.6% of the variance in the data. The analysis was a Principal Components Factor analysis with Varimax rotation. The factor analysis indicates that these five questions effectively provide a measure of auditor liability exposure. Factor scores were saved and used in the ANOVAs described in the sections below to represent auditor liability perceptions.

H1: More Auditable vs. Less Auditable Internal Control Weaknesses

H1 predicts that auditors will be viewed more favorably (less favorably) when they fail to accurately report a material weakness in a more auditable (less auditable) internal control. First, this hypothesis is tested using the responses to the question ‘How would you vote?’ as the dependent variable (response options ‘Liable’ or ‘Not Liable’). Since this particular dependent variable measure was dichotomous, a binary logistic regression analysis was employed to predict the probability that a participant would find the auditor ‘Liable’ vs. ‘Not Liable’. This test provides results in the form of an odds ratio, which communicates the influence of the independent variables on the dependent variable. Results will also provide an estimate of the model’s percentage of correct predictions of the dependent variable. The proposed model is compared to the intercept only model, and will be considered an improvement over the intercept-

only model when the Nagelkerke r-squared and percentage predictions are higher in the proposed model.

Results of the model with independent variables ‘MW Type’ (H1) and ‘Disclosure’ (H2) are presented in Panel A of Table 16. Results for H1 will be discussed first, with all results for H2 to be discussed separately in the next section. A test of the model in comparison to the intercept-only model (excluding all independent variables and interactions) was statistically significant, $\chi^2(1, N = 93) = 11.966, p=0.003, \text{Nagelkerke } R^2 = 0.166$. This model successfully predicted the ‘Not Liable’ outcome 80.0% of the time and the ‘Liable’ outcome 39.4% of the time, with an overall rate of correct predictions of 65.6%. ‘MW Type’ is significant in this model ($p=0.002$), with the odds ratio indicating that individuals in the ‘More Auditable’ conditions are 0.254 times less likely to find the auditor liable in comparison to individuals in the ‘Less Auditable’ conditions. Overall, results of this model support H1, which proposed that auditors failing to accurately assess a more auditable internal control would be evaluated more favorably by jury members.

The second test of H1 examines the participants’ responses to the questions ‘What dollar amount in compensatory damages would you recommend be awarded to the stockholders?’ (\$0 to \$100,000,000) and ‘What dollar amount in punitive damages would you recommend be awarded to the stockholders?’ (\$0 to \$200,000,000). All participants were included in this analysis, with \$0 entered as damages for individuals who voted ‘Not Liable’. MANOVA was conducted with the dependent variable represented by the dollar value for compensatory and punitive damages. Panel B of Table 16 provides details on the outcome of this MANOVA. A significant effect was found overall for the independent variable ‘MW Type’, Wilks lambda= 0.849, $F(2,93) = 7.835, p=0.001$. The partial Eta squared for ‘MW Type’ was 0.151, which

means that this independent variable accounted for 15.1% of the variance in the dependent variable. A follow-up analysis was performed using the log of the damage awards, with very similar results to the above analysis. Univariate analyses of the variance (ANOVAs) were also performed for each of the two individual dependent variable measures to further understand the influence of the internal control weakness type on auditor litigation exposure as measured by compensatory and punitive damage awards. Panels C and D of Table 16 report the results of these analyses.

Individual ANOVAs of the participants' compensatory and punitive damage awards indicate a significant main effect for the independent variable 'MW Type' on the dependent variable measures for compensatory and punitive damages ($p=0.000$ and 0.003 accordingly). Overall, compensatory and punitive damages awarded in the 'More Auditable' conditions are significantly lower than the compensatory and punitive damages awarded in the 'Less Auditable' conditions. Results suggest that measuring auditor liability through compensatory and punitive awards provides support for H1, indicating that the auditor is evaluated more favorably when they fail to accurately evaluate a more auditable internal control weakness.

The final test of H1 examines auditor liability as measured by the mean factor score (the sum of the standardized factor scores multiplied by the individual item factor loadings) of the responses to the series of five auditor liability questions detailed in the section above. An ANOVA was performed with the factor score of the measures of auditor liability perceptions as the dependent variable, resulting in a significant effect for the independent variable 'MW Type', $F(2,93) = 8.021, p=0.006$. Panel E of Table 16 provides a summary of these results. Comparison of the mean factor scores indicates that the individuals in the 'More Auditable' conditions

evaluated the auditor more favorably in comparison to ‘Less Auditable’ conditions, providing further support for H1.

H2: Unqualified without Disclosure vs. Unqualified with Voluntary Disclosure

H2 predicted that auditors providing an unqualified Section 404 report with a voluntary disclosure of a significant deficiency would be evaluated more favorably, compared to when they provide an unqualified report with no disclosure. This hypothesis is tested in the same models described above for H1, with results reported in Table 16. First, responses to the question ‘How would you vote’ (response options ‘Liable’ or ‘Not Liable’) were entered as the dependent variable in a binary logistic regression analysis. ‘Disclosure’ is marginally significant in this model ($p=0.056$), with the odds ratio indicating that individuals in the conditions where the auditor provided voluntary disclosures of a significant deficiency in internal controls were 0.478 times less likely to find the auditor liable in comparison to individuals in the conditions where the auditor did not provide a disclosure. Therefore, results of this model provide moderate support for H2.

Panel B of Table 16 provides the results of a MANOVA of the dollar amount of compensatory and punitive damages assessed against the auditor, indicating that a significant effect was not found for the independent variable ‘Disclosure’, Wilks lambda= 0.976, $F(2,93) = 1.065$, $p=0.175$. A follow-up analysis performed using the log of the damage awards did not change these results. Results of this test do not support H2, indicating no significant differences in punitive or compensatory damages assessed against the auditor due to the level of disclosure within the Section 404 report. As shown in Panels C and D of Table 16, individual ANOVAs of the participants’ compensatory and punitive damage awards do not indicate a significant main

effect for the independent variable ‘Disclosure’ on the dependent variable measures for compensatory and punitive damages ($p=0.197$ and 0.204 accordingly).

Panel E of Table 16 provides a summary of the results of an ANOVA with the factor score of the measures of auditor liability perceptions as the dependent variable. A significant effect was found for the independent variable ‘Disclosure’, $F(2,93) = 5.207, p=0.025$.

Comparison of the mean factor scores supports H2, indicating that the individuals in the Disclosed conditions evaluated the auditor more favorably in comparison to Not Disclosed conditions.

Additional Test: Interaction between ‘MW Type’ and ‘Disclosure’

As an additional test of the participants’ responses to the questionnaire, each of the tests described above were revisited to examine whether a significant interaction exists between the two independent variables in this study (‘MW Type’ and ‘Disclosure’). First, a logistic regression analysis was performed with the dependent variable represented by the participants’ liable/not liable judgments. Independent variables in this model are ‘MW Type’ (H1), ‘Disclosure’ (H2), and an interaction term ‘MW Type’ x ‘Disclosure’. As shown in Table 17, a test of the model in comparison to the intercept-only model (excluding the independent variables) was statistically significant, $\chi^2(3, N = 93) = 14.678, p=0.002, Nagelkerke R^2 = 0.201$. Interestingly, the significance of both main effects (‘MW Type’ and ‘Disclosure’) ($p=0.128$ and 0.386 accordingly) disappear when the interaction is included; and the interaction effect (‘MW Type’ x ‘Disclosure’) is marginally significant ($p=0.057$). The odds ratio indicates that individuals in the ‘Disclosed/More Auditable’ condition were 0.191 times less likely to find the auditor liable in comparison to individuals in the other three conditions. Also notable is the

comparison of this model to the two logistic regression models proposed in this study for H1 and H2 (Panel A of Table 16). This second model, which includes the hypothesized main effects and an interaction effect, is superior with a higher r-squared of 0.201 compared to the main effects only model r-squared of 0.166. Overall, results of this model indicate that auditors providing voluntary disclosures of more auditable internal control issues would be evaluated the most favorably by jury members, which is consistent with the descriptive statistics described in the sections above and presented in Panel A of Table 15.

Table 16 Panel B provides details on the outcome of a MANOVA with the dependent variable measures for compensatory and punitive damages, which indicates that the interaction between 'MW Type' and 'Disclosure' was not significant, Wilks lambda= 0.984, $F(2,93) = 0.726$, $p=0.244$. Panels C and D of Table 16 report results of individual ANOVAs of the participants' compensatory and punitive damage awards, which do not indicate a significant main effect for the interaction between 'MW Type' and 'Disclosure' ($p=0.847$ and 0.372 accordingly).

Panel E of Table 16 provides a summary of the results of an ANOVA with the factor scores of the measures of auditor liability perceptions as the dependent variable. The interaction effect for 'MW Type' x 'Disclosure' was also not significant in this model, $F(2,93)=1.011$, $p=0.347$. Comparison of the mean factor scores, shown in Panel E of Table 16 indicates that the individuals in the 'More Auditable/Disclosed' condition evaluated the auditor more favorably in comparison to the other conditions, with the 'Not Disclosed/Less Auditable' condition providing the least favorable evaluation of the auditor. These results taken indicate that 'MW Type' and 'Disclosure' interact to affect participants' decisions on whether the auditor is liable or not liable

but do not affect the amount of damages awarded or the participants' perceptions of the degree of liability.

Summary of Results

Table 18 provides a summary of the results of the analyses above. H1, which predicted that the type of internal control weakness would influence jurors' evaluations of auditors, was supported by the results of all tests. Significant effects for this independent variable were found in the analyses of the participants liable/not liable judgments, in the analysis of compensatory and punitive damages awarded, and in the analysis of the participants' perceptions of the auditor's liability as measured by the factor scores of a series of seven-point scaled questions. H2, which predicted that voluntary disclosures of significant deficiencies would favorably influence auditor liability, was supported when testing the participants' liable/not liable judgments, and in the analysis of responses to the series of the factor scores of seven-point scaled questions regarding juror's perceptions of auditor liability. Finally, the interaction effects for the variables examine in H1 and H2 examined in the additional analysis were significant for the first judgment, where participants were asked to respond whether the auditor should be liable/not liable. Implications of these results are discussed in the conclusions section below.

Conclusions

Overall, H1, which predicted that auditors would be found less liable by jurors when the auditor failed to accurately evaluate an internal control weakness that is more auditable, is supported strongly in this study. All measures for auditor liability exposure supported this conclusion, including measures of the participants' judgments of whether the auditor is liable/not liable, the participants' assessment of punitive and compensatory damages, and the individuals'

perceptions of auditor's degree of liability. Specifically, the participants were less likely to find the auditor liable when the auditor failed to properly evaluate a material weakness in internal controls when the control in question was more auditable, compared to when the control in question is less auditable. The participants also awarded lower punitive and compensatory damages to auditors under this condition, and evaluated the auditor more favorably overall when asked a series of questions designed to gauge their perceptions of auditor liability.

The results for H1 suggest that auditors may be exposed to more liability for their subjective decisions, which may imply that auditors should be conservative with their audit procedures and financial reporting decisions when evaluating less auditable internal controls. This finding supports attribution theory, in that jurors are more likely to attribute blame to an individual when their decisions were made based on their judgment, and less likely to attribute blame to an individual relying on an external source to guide their decisions (i.e., rules or evidence). Since auditors tend to rely more on professional judgment when assessing internal controls that are more subjective in nature (i.e., the control environment or management integrity), the results of this study suggest that auditors should be aware that they will likely be held responsible for this decision. This finding also suggests that when auditors are able to produce more solid evidence in court, jurors will be less likely to place blame on them. When the auditor can provide audit evidence in court, they may be able to place the blame for a failure on another source, such as the evidence provided by the client or the rules guiding the profession. Therefore, the results of this study suggest that auditors have an incentive to collect and document sufficient evidence if it is available to protect themselves from liability in the event of an audit failure. Future research in this area could extend on these findings by examining how auditor liability differs when auditors are following rules or principles-based standards. The

findings of this study may indicate that auditors may be more exposed to liability when interpreting principles-based standards as a result of the subjectivity involved in auditors' principles-based judgments.

The results for Hypothesis 2 are mixed. This hypothesis predicted that voluntarily disclosing the deficiency would result in the auditor being evaluated more favorably by jurors. Results do suggest that auditors may be able to significantly influence whether they will be found liable in court by a jury by providing a voluntary disclosure of a significant deficiency in an unqualified Section 404 report. Examining the responses to the individual measures of auditor liability also suggests that overall perceptions of auditors can be positively influenced by providing such voluntary disclosures. However, jurors' assessments of damages in the event of a liable verdict do not appear to be favorably influenced by voluntary disclosures in the Section 404 report alone. Although this last finding does not support H2, damages would not be awarded at all in the event that the auditor is found not liable. Therefore, since participants' liable/not liable judgments do support H2, these results suggest that auditors can utilize the Section 404 report to provide a signal of potential risks of internal control issues within a company, and that this signal will lead jurors to evaluate them more favorably in the event of a trial implicating the auditors. This finding is important, particularly since study one of this dissertation did not support a significant difference in lawyers' assessments of litigation exposure for auditors who provided voluntary disclosures within the Section 404 report. Overall, finding that auditors are able to positively influence the outcome of a jury trial by providing such disclosure suggests that auditors should view the Section 404 report as an opportunity to protect themselves from liability in the event of a jury trial.

Additional analysis of the participants' judgments in this study supports a significant interaction effect between the auditor's disclosures and the type of material weakness for participants' initial decision whether the auditor is liable or not liable. This result indicated that the auditors are significantly more likely to be found not liable when they voluntarily disclosed a more auditable internal control issue, in comparison to all other conditions. Examination of the descriptive statistics for the results of the study reveals that 92.0% of the individuals found the auditor not liable when the auditor voluntarily disclosed a more auditable internal control issue, with an average of only \$4 million in compensatory damages, and no individuals awarding punitive damages to the shareholders. Overall, the type of internal control weakness (H1) and voluntary disclosures of internal control issues within the Section 404 report (H2) each seem to have significant effects on auditor liability exposure, but the combination of a more auditable control and providing a voluntary disclosure appears to provide auditors with a significant amount of protection from legal liability in a jury trial. Therefore, auditors may wish to consider each of these findings in conjunction by carefully considering how well they will be able to collect and document evidence on the internal controls evaluated during an audit when deciding how much to disclose within the Section 404 report.

One limitation of this study is the online setting, which can exclude certain types of individuals from the sample. Specifically, the technology requirements for this study would have prevented individuals who did not have a high speed internet connection or audio capabilities from participating in the study. However, this limitation would be most likely to bias the sample to a younger population, and since the average age of the sample for this study was 46 years old with almost 9% of the sample over 65 years old, the potential limitation due to technology limitations or computer literacy may not be a significant issue with this study. The online setting

also limits the ability for the researcher to control for environmental factors that could potentially influence the participants' attentiveness to the study. Another limitation of this study is the use of a summary of a realistic court case in the place of a real, live court case. This limitation poses a potential threat to external validity, but allowed the researcher to experimentally manipulate the variables examined in the study. Future research could expand on the results of this study by examining auditor liability in a live setting with a simulated trial, which would provide insight in to the potential for differences in juror decisions based on how the simulated case is delivered to participants.

Overall, this study provides a valuable addition to understanding auditor litigation by examining how Section 404 report disclosures can impact juror decisions if litigation should occur, particularly when the auditor fails to accurately assess the impact of different types of control deficiencies. Therefore, the study provides practical insights for the current debate regarding the liability exposure for auditors following SOX, by suggesting that auditors can potentially lessen their liability exposure by increasing the transparency of their Section 404 reports. Finding that auditors are more likely to be found liable if the internal control in question is less auditable and more reliant on the auditor's professional judgment may be a concern for audit firms. Auditors may wish to evaluate the less auditable deficiencies more closely or report an adverse opinion on internal controls whenever such deficiencies are found, as voluntarily disclosing significant deficiencies in less auditable internal controls does not appear to decrease their liability exposure to the same extent as disclosing more auditable deficiencies.

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STUDY THREE: AN EXAMINATION OF THE INFLUENCE OF AUDIT COMMITTEE MEMBER INDEPENDENCE AND EXPERTISE ON JURORS' PERCEPTIONS OF AUDITOR INDEPENDENCE AND ATTRIBUTIONS OF LIABILITY

Introduction

The Sarbanes-Oxley Act of 2002 (SOX) was created with the intent to improve financial reporting and auditing for public companies (Jennings et al., 2006). Many of the provisions of SOX specifically focus on the overall improvement of auditor independence, attempting to create an environment in which auditors are faced with fewer conflicts of interests that could interfere with their ability to make independent decisions during the audit (Jennings et al., 2006; DeZoort et al., 2008). SOX addressed the issue of auditor independence in one way by creating higher standards for individuals who serve on the audit committee, specifying that audit committee members meet minimum levels of independence and expertise (DeZoort et al., 2008). According to SOX, public companies must establish that audit committee members are independent and publicly disclose whether at least one of the audit committee members is considered an expert in finance or accounting (Jennings et al., 2006).

Many studies indicate that financial reporting and auditing improve when the audit committee contains members who are more independent and/or experts (DeZoort et al., 2002). These conclusions provide preliminary support that improving the independence and expertise of audit committee members influences auditor independence. The purpose of this study is to examine the impact of the audit committee member independence and expertise (as required by SOX) from a different perspective, focusing on how jurors' perceptions of auditor independence

and auditor liability are influenced by audit committee member expertise and independence in a litigation setting.

This study is important because the requirements of SOX still allow some leeway in how companies interpret the level of need for financial expertise and independence on an audit committee (DeZoort et al., 2002; Zhang et al., 2007; Chan and Li, 2008). While some companies remain minimally compliant with SOX with very few audit committee members qualifying as expert and/or independent, other companies have a larger number of experts and independent members on their audit committee (Zhang et al., 2007; Chan and Li, 2008).

This increased understanding of how audit committee member expertise and independence may influence jurors' perceptions of auditor independence and liability in a litigation setting contributes to both academic research and practice. Past research on corporate governance indicates that judges are likely to evaluate auditors more favorably under conditions of high corporate governance (Jennings et al., 2006). This study extends prior research by examining how the individual characteristics of audit committee expertise and independence may influence jurors' perceptions of auditor independence. By isolating the effects of these two audit committee characteristics, this study provides a more in-depth understanding of how specific characteristics of audit committee members can impact auditor liability exposure. As audit firms are faced with a highly litigious environment in the U.S. and wish to maintain client portfolios with acceptable levels of litigation risk (Cunningham, 2004), auditors may find the results of this study useful in evaluating the liability risk for new clients, and further understand how contextual factors related to their client's characteristics may influence court decisions.

In this study, an experiment was conducted to examine how audit committee member expertise and independence influences jurors' perceptions of auditor independence and liability.

Participants were asked to review a case where undetected fraudulent activity resulted in the bankruptcy of a public company, and shareholders are suing the auditor for damages. The case stated that the fraud was able to occur as a result of a weakness in internal controls. The particular internal control issue at fault was identified by auditors in the previous year, but after discussing the issue with the audit committee and management, the auditors ultimately decided not to report the internal control issue to the public. The case also provided details about the members of the audit committee, which were manipulated in a 2x2 between-subjects design across four conditions representing high vs. low independence and high vs. low expertise. Participants were asked to provide their perceptions about audit committee independence, audit committee expertise, auditor independence, and auditor liability. They were also asked to decide if the auditor should be found liable for negligence, and assess punitive and compensatory damages in the event of a liable verdict.

The proposed model depicted in Figure 1 was tested with components based SEM using partial least squares analysis to examine how jurors' perceptions of audit committee independence and audit committee expertise influence their judgments about auditor independence and auditor liability. Results suggest that perceptions of audit committee independence can positively influence perceptions of auditor independence and auditor liability. Additionally, higher perceptions of auditor independence were found to have a positive influence on jurors' auditor liability judgments. Results do not support a significant relationship between audit committee expertise and perceptions of auditor independence or auditor liability. However, audit committee independence and audit committee expertise interact to affect auditor liability, such that auditors are evaluated most favorably when audit committee members are highly expert and independent. Interestingly, auditors are evaluated least favorably overall when audit

committees contain high levels of expertise and low levels of independence, indicating that expertise in audit committee members may not always have a positive impact on auditor liability exposure.

The following sections provide an overview of the increased requirements related to audit committees. Included in this overview is an exploration of how the related perception of auditor independence has the potential to impact juror decisions in a litigation setting. Then, hypotheses are developed based on theory and research, followed by a description of the research method that tests these hypotheses. Last, results and implications of this study are discussed.

Theory and Hypothesis Development

The Sarbanes Oxley Act of 2002 and the Audit Committee

SOX Section 301 requires that audit committee members meet minimum independence requirements. Independence for an audit committee member is defined as either (1) having no financial ties to the company other than acting as a member of the committee or board of directors or (2) having no affiliation with the company or its subsidiaries (Chun-Keung et al., 2007). SOX Section 407 requires the audit committee to disclose whether they maintain at least one financial expert on the committee, or why they do not have an expert on the committee (Zhang et al., 2007). This section states that experts must have education or experience in a role that would prepare the individual to understand accounting principles and financial statements, such as a controller or a financial officer (U.S. House of Representatives, 2002). Beyond these minimal requirements to disclose the presence of an expert member, audit committees tend to vary in composition, with some having members with more/less expertise and independence than others (Zhang et al., 2007).

Because of the perceived importance of the audit committee as a corporate governance mechanism, researchers have investigated the impact of audit committee composition on the quality of the financial reporting and audit process, with a large portion of research focusing on the specific characteristics of audit committee member expertise and independence (DeZoort et al., 2002¹⁰). The following sections provide a summary of the findings related to these characteristics, and the impact these particular audit committee traits may have on auditor liability in a trial setting. Then, four hypotheses are developed to propose the overall research model shown in Figure 1.

Audit Committee Expertise and Negotiating Power: Perceptions of Auditor Independence

SOX Section 407, which requires audit committees to disclose the expertise of their members, has inspired a large stream of research, focusing on the specific characteristics of expert members and their impact on the quality of the audit process and the resulting financial report (DeZoort et al., 2008). Past research indicates that expertise within the audit committee is associated with signals of higher quality auditing and financial reporting (DeZoort et al., 2002). Overall, the rationale behind the importance of having an expert member on the audit committee is that expert members have the knowledge to make more educated decisions in the event of a conflict between the auditor and management. This knowledge allows them to actively discuss issues with the auditor and management, which provides an additional source of insight and could lead to better decisions.

¹⁰ DeZoort et al. (2002) provides a detailed synthesis and review of literature on audit committees and develops a taxonomy based on this literature. Audit committee composition is one large component of this taxonomy, with predominant factors being audit committee member expertise and independence.

Since the auditing and financial reporting process is often highly complex (DeZoort et al., 2002), and current audit committees are expected to be more involved in auditing and reporting decisions than in the past (Chan and Li, 2008), the ability to make educated decisions is crucial to ensuring the highest quality reporting possible. Past research supports this assumption, as financial expertise on an audit committee is associated with a number of indicators of high quality auditing and reporting. For example, higher levels of expertise on audit committees are associated with less restatement activity (Abbott et al., 2004) and favorable reactions from the market (DeFond et al., 2005). Audit committees with expert members have a greater likelihood of siding with the auditor in a dispute (DeZoort and Salterio, 2001; DeZoort et al., 2008). Companies with expert members on their audit committees also engage in less earnings management (Xie et al., 2003; Carcello et al., 2006), and have a lower incidence of internal control weaknesses (Zhang et al., 2007; Bedard et al., 2007). Overall, these findings suggest that financial reporting improves when audit committees contain expert members.

Research indicating that expert audit committee members are more likely to side with auditors in the event of a conflict (DeZoort and Salterio, 2001; DeZoort et al., 2008) provides some evidence that the level of expertise does lead to a more independent decision-making environment for auditors, as intended by SOX. Kalbers and Fogarty (1993) provide insight that may explain why this phenomenon occurs, suggesting that audit committee effectiveness is perceived as a function of the types and extent of audit committee power. The concept of power described in the Kalbers and Fogarty (1993) article originated from various sources in academic research in political science and sociology, which typically define power as the ability to have control over a social situation in the presence of resistance (Blau 1964; Weber, 1968).

The specific link between expertise and power can be traced back to research by French and Raven (1957, 1974), who developed a typology of power to explain the different characteristics that may influence the balance of power in a situation. Expertise was included as one of the sources of power in this typology, suggesting that individuals with expertise will gain more power. Kalbers and Fogarty (1993) explore this concept of power in the context of the qualifications of audit committee members, proposing that power in the form of expertise is highly associated with financial reporting effectiveness. Since expert members are required to have finance or accounting specific knowledge, they would not have to rely as heavily on the opinions of management and auditors to understand financial reporting or internal control issues. Researchers suggest that this expertise provides an additional level of power to the audit committee; and, in the event of a dispute with the auditor, management will likely have less control over the outcome (Kalbers and Fogarty, 1993).

This concept of negotiation power is highly important from an audit perspective, as the audit process is often characterized as a constant negotiation process between auditors and their clients (Gibbins et al., 2001; DeZoort et al., 2008). Negotiation power can significantly influence the auditor's ability to perform high quality audits by impacting the way that the auditor interacts with their clients to resolve conflicts over financial reporting. Unfortunately, research indicates that management often has a significant amount of power over the audit process. Since management is often more knowledgeable about their business and industry, their expert knowledge can be viewed as a source of power in these interactions (French and Raven, 1957; Kalbers and Fogarty, 1993). Other sources of power identified by French and Raven's (1957; 1974) typology are power over resources and power over information. Management arguably has more power over the resources and information of the company compared to auditors, which

additionally contributes to managements' increased power over the audit process. The more power management has over audit decisions, the less independent the auditor becomes in their decision-making (Kalbers and Fogarty, 1993). Auditor independence is generally perceived as a significant factor in determining financial reporting quality, and is a necessary component of a successful audit and financial reporting process (Jennings et al., 2006; Brandon and Mueller, 2006; 2008). Therefore, auditor negotiation power, and the resulting impact on auditor independence, has been a focus of researchers and regulators seeking to improve the quality of financial reporting.

One major solution that has emerged to combat the lack of auditor negotiation power has been the expansion of the role of audit committees. Audit committees now act as an intermediary between auditors and management in the event of a dispute, which has not always been the case (DeZoort and Salterio, 2001; DeZoort et al., 2008). In the past, direct negotiations between management and auditors were more common when an auditor and management disagreed on an accounting issue (DeZoort and Salterio, 2001; DeZoort et al., 2008). This finding suggests that auditors have more negotiation power when audit committees play a role in the negotiation process. Therefore, the role of the audit committee as an intermediary between auditors and management is directly related to auditor independence (Jennings et al., 2006). The addition of another neutral party participating in the audit process decreases the amount of direct influence that management has over audit decisions, thus creating a more independent auditor (Kalbers and Fogarty, 1993). The overall quality of the financial reporting process is improved when auditors are independent, as the auditors are less likely to allow management to control their audit decisions and influence their judgments.

In addition to finding that expert members on the audit committee improve auditor independence in fact, research indicates that general perceptions about the audit committee can influence *perceptions* of auditor independence (Brandon and Mueller, 2008). Prior research indicates that when auditor independence is influenced in fact, individuals' perceptions of auditor independence tend to be influenced in a similar manner (Brandon and Mueller, 2008). These findings support the link between auditor independence in fact, which is measured with indicators of higher quality decision-making and reporting, and auditor independence in appearance, which is measured by individuals' perceptions of auditor independence. Much of the research in this area has a practical basis for examining the factors that will influence perceptions of independence, and tends to focus on the factors that should logically decrease independence. One example of this research finds that auditor tenure, a much debated issue that has been identified as a contributing factor to independence in fact, negatively influences jurors' perceptions of auditor independence (Brandon and Mueller, 2008). Another study examined how judges perceive auditors, finding that when auditors perceive the audit committee to be strong, versus minimally compliant, they evaluate the auditor to be more independent (Jennings et al., 2006). These two studies were motivated by research supporting factors that influence auditor independence in fact, and found that individuals' perceptions follow a similar logical pattern.

Overall, the expertise of audit committee members has been shown to positively influence auditing and financial reporting in practice, with some researchers suggesting that this positive effect is because of improved auditor independence (DeZoort et al., 2008). Research indicates that in the post-SOX environment, audit committees are becoming more involved in the negotiations over disagreements that occur during an audit, providing an intermediary between

the auditor and management in the event of a disagreement (DeZoort et al., 2008). The expertise of audit committee members has been shown to influence these negotiations, as audit committees with expert members are more likely to side with the auditor in the event of a disagreement between management and the auditor (DeZoort and Salterio, 2001; DeZoort et al., 2008). This implies that having an expert member on the audit committee may influence the balance of power in the auditor-client relationship by shifting power over audit and financial reporting outcomes away from management as the sole influence over the auditor's decisions (Kalbers and Fogarty, 1993). When this power is shifted away from management, the auditor's decisions are likely to become more independent (Kalbers and Fogarty 1993). This research suggests a positive relationship between audit committee member expertise and auditor independence as auditors are pressured less by management in the decision process (DeZoort and Salterio 2001; DeZoort et al., 2008). Based on prior research on auditor independence, the improvement of auditor independence in fact is likely to indicate that perceptions of auditor independence will be influenced in a similar manner (Brandon and Mueller, 2008). This phenomenon likely occurs due to the perception of audit committee expertise as a source of power over the financial reporting process (Kalbers and Fogarty 1993), allowing audit committee members and auditors to perform their duties independently of management's influence. Therefore, in the event of an audit failure, the audit committee that has members with high levels of expertise may create a signal to jurors that the auditor was able to make more independent decisions based on their professional judgment, as opposed to reacting to pressures and motivations to retain the client. Based on this argument, the following hypothesis is proposed:

H₁: Jurors will perceive auditors as more independent when they perceive that the client's audit committee contains higher levels of expertise than when they perceive that the client's audit committee contains lower levels of expertise.

Audit Committee Independence and Negotiating Power: Perceptions of Auditor Independence

Overall, most research indicates that higher levels of independence on an audit committee generate higher quality financial reporting and more independent audits. Higher levels of independence on an audit committee are associated with lower cost of debt (Anderson et al., 2004), lower likelihood of fraud (Beasley et al., 2000; Beasley 1996), and less earnings management (Klein, 2002). There are also indications that less independent audit committees tend to side with management over the auditor (Carcello and Neal, 2000).

Although SOX requires that members be independent, the interpretation of this requirement has varied in practice, ranging from individuals who are retired executives of the company, individuals with less than 20% ownership of stock, to fully independent outside members who do not own stock in the company. Although all audit committee members may be independent by SOX standards, individuals with stock ownership or past ties to the company may be perceived as less independent than members who have no stock ownership or past ties to the company.

Similar to the arguments presented above related to audit committee expertise, perceptions of audit committee independence are important to consider within a trial setting because of the potential impact on perceptions of auditor independence. Research generally supports that higher levels of audit committee member independence are positively related to indicators of higher quality financial reporting and auditing (DeZoort et al., 2002). Some of this research even directly asserts that auditor independence is improved when audit committee

members are independent, and that these members of the committee are more likely to side with the auditor in disputes with management (Kalbers and Fogarty, 1993; Carcello and Neal, 2000). The rationale behind these findings is that when audit committee members are not directly linked to the company (i.e., no large ownership of stock or direct employment), they are able to provide a more objective opinion on disputes that may arise between the auditor and management (Klein, 2002). In contrast, if audit committee members have a direct relationship with the company, they may be more likely to make decisions about the audit based on their own self-interest as opposed to the public interest (Klein, 2002).

To further explain how audit committee independence influences the decisions made by the committee members, the concept of power once again emerges as an important theoretical element. One of the components of power identified in social theory is the need for a will to take action (Kalbers and Fogarty, 1993). Without the will to act, the individual may not follow through and exert their power over a situation. Although audit committees are given the legitimate power of oversight over the financial reporting and audit processes, a lack of will to exert this power may compromise their decisions (Kalbers and Fogarty, 1993). Specifically, when audit committees have a direct financial stake in the company, they may not have the will to exert their power over management in the event of a disagreement between management and the auditor, particularly when doing so would have a negative financial impact on the committee member.

The findings of Carcello and Neal (2000) support this theory, indicating that the independence of the audit committee members does influence their decision-making. Furthermore, the findings of Carcello and Neal (2000) suggest that auditors may be subjected to fewer pressures to side with management in the event of a dispute in the presence of a more

independent audit committee. This finding suggests that more independent audit committee members have the will to exert their power over negotiations between management and the auditor, thus providing an independent intermediary in the event of a disagreement during an audit. When auditors are able to distance their decisions from management's pressure, they are more likely to make more independent decisions (Kalbers and Fogarty, 1993). Since research suggests that auditor independence is influenced by audit committee member independence, perceptions of auditor independence are likely to be influenced in a similar way. Therefore, the following hypothesis is proposed:

H₂: Jurors will perceive auditors as more independent when they perceive that the client's audit committee exhibits a higher level of independence than when they perceive that the client's audit committee exhibits a lower level of independence.

Audit Committee Expertise, Audit Committee Independence, and Auditor Independence

Research indicates that companies who have expert audit committee members are likely to have less earnings management (Carcello et al., 2006). However, committees with expert members who are also independent are even less likely to allow earnings management (Carcello et al., 2006), indicating that an interaction between the two qualities should produce higher quality financial reporting. Further supporting this claim that both independence and expertise of audit committee members are joint indicators of higher quality financial reporting is the finding that firms with audit committees containing members who are identified as executives from outside companies, arguably characterized as both highly expert and independent, are valued higher (Chan and Li, 2008). In addition, higher levels of audit committee independence and expertise have been associated with a decreased incidence of internal control problems

(Krishnan, 2005), and increased audit committee effort and involvement in audits (Raghunandan et al., 2001).

Overall, the research discussed above is aligned with theory of social power. Some researchers suggest that individuals need both power and the will to exert their power in order to effectively influence a social situation (Kalbers and Fogarty, 1993). The Raghunandan et al. (2001) finding indicating that audit committees are more involved in audits when members exhibit higher levels of expertise and independence supports this theory. Specifically, theory suggests that expertise of the audit committee members provides the source of power (French and Raven, 1957), and the independence of the audit committee members lessens the potential for conflicts of interest that could inhibit the will to exert their power. Therefore, an audit committee with high levels of expertise and independence should be expected to become more involved in audits and fulfill the important role of an independent intermediary between management and the auditor in the event of a dispute.

Overall, past research and social theory suggests that audit committees with both high levels of expertise and independence may be the most beneficial from an auditor independence perspective. The expertise of audit committee members provides a source of power for the committee members in a situation where management is likely to attempt to exert influence over their decisions, which would allow committee members to influence reporting decisions. However, a lack of audit committee independence could decrease the audit committee members' will to exert their power over the audit. Therefore, without the will to act, any other sources of power (i.e., expertise) will likely be irrelevant (Kalbers and Fogarty, 1993), suggesting that both expertise and independence are necessary to promote effective audit committee involvement in the audit process. Past research also suggests that more audit committee involvement with the

audit process shifts the balance of power in an audit away from management (Kalbers and Fogarty, 1993). In this particular situation, auditors would be more able to make decisions based on their professional judgment, not based on pressures from management (Kalbers and Fogarty, 1993). These findings, indicating that audit committee members with expertise and independence are more involved in audits, support the potential for improvements in auditor independence (in fact) when audit committees contain both independent and expert members. Based on prior research that suggests perceptions of auditor independence are similarly impacted by factors that impact auditor independence, the following is proposed:

H₃: Jurors will perceive auditors as more independent when they perceive that the client's audit committee exhibits both a high level of independence and expertise.

Auditor Independence and Auditor Liability

Although auditors may be independent in fact, in a trial setting the appearance of independence is more important and would be more likely to influence the juror or judge's perception of the auditor's independence (Jennings et al., 2006; Brandon and Mueller, 2006; 2008). Perceptions of auditor independence are important to auditors in a litigation setting because of the potential that jurors or judges will perceive them as more blameworthy when working under conditions of low independence (Jennings et al., 2006; Brandon and Mueller, 2006; 2008). A common argument from the plaintiff in trials concerning auditor liability is that the auditor is motivated by the money they receive from performing the audit and make decisions that please the client (Brandon and Mueller, 2006; 2008). Attribution theory suggests that the motivations behind an individual's actions are important when others are deciding

whether blame should be placed on the individual for their actions (Brandon and Mueller, 2006). When individuals are perceived to have intentionally acted in response to a motive that increases their personal gain, they are attributed with more blame (Alicke et al., 1990). Prior research indicates that if auditors are perceived as operating under conditions of low independence, jurors tend to perceive that they acted with intent motivated by their desire to please the client, and blame is more likely to be attributed to the auditor (Brandon and Mueller, 2006).

The perception of independence discussed above is crucial to the outcome of a trial, as attribution theory and past research suggests that jurors are more likely to find the auditor liable for negligence and award damages when they are perceived as being less independent (Jennings et al., 2006; Brandon and Mueller, 2006, 2008). This increased perception of auditor independence would most likely lead to a more favorable outcome for the auditor in a trial setting (Jennings et al., 2006; Brandon and Mueller, 2006, 2008). Therefore, the following hypothesis proposes:

H₄: Jurors will evaluate auditors as more liable when they perceive the auditor to be less independent than when they perceive the auditor to be more independent.

Research Method

Figure 2 provides the research model used in this study, based on the hypotheses (H1-H4) outlined in the sections above. The study utilized a 2x2 between subjects design, manipulating the level of audit committee independence (low/high) and audit committee expertise (low/high). Table 19 depicts this design in a table showing how audit committee independence and expertise were manipulated across four conditions. After reading a case containing the manipulated characteristics, participants' responded to a series of questions designed to measure their

perceptions of each construct presented in the model shown in Figure 2 (audit committee independence, audit committee expertise, auditor independence, and auditor liability). This model is tested using Partial Least Squares (PLS), which allows the researcher to model paths with latent variables. A follow-up analysis is also conducted to examine the influence of the manipulated variables on the individual perceptions included in the proposed model.

Experimental Task and Procedures

The experiment was conducted in an online environment using Survey Monkey software (www.surveymonkey.com), allowing participants to complete the task on their own time and at a computer of their choice. Participants were randomly assigned into one of the four manipulated conditions in this study and were sent an email with an embedded link to access the corresponding online case materials and survey. Once accessed, the participants were prompted to read a summary of their rights and responsibilities as participants and provide their consent to participate by checking a box and continuing to the next screen to begin the study. The first phase of the study asks participants to review a case study from the perspective of a jury member. This case study was presented to them in written text format accompanied by an audio recording of the text. Participants were directed to listen to the audio recording and follow along by reading the text. This method has been utilized in previous studies to encourage attentiveness and improve reading comprehension when the information is complex and time consuming to read (Kadous 2000; 2001).

The case study provided to participants described a scenario where auditors failed to disclose a client's internal control weaknesses that resulted in fraudulent actions, and were being sued by stockholders for negligence. Although auditors did not discover fraud in this case, they

discovered and raised concerns over the particular control deficiency that allowed fraud to occur, notifying both management and the audit committee. Management disagreed with the auditor's concerns, and expressed this opinion to the audit committee. The audit committee sided with management and deemed that the deficiency was not likely to be material, and did not recommend that the auditor perform additional procedures. In the end, the auditor decided not to expand their audit procedures or disclose anything about the control deficiency in their audit reports. Participants were provided with details related to the audit committee's level of expertise and independence as part of the case, which were manipulated between groups in a 2x2 factorial design resulting in four different scenario combinations, as detailed in Table 19.

The scenario for low expertise indicated that there were no expert members on the committee. The company properly disclosed that they were not able to find an individual meeting their specifications as an expert, but that they feel the collective knowledge of the audit committee covers the necessary knowledge needed to fulfill their roles. This would qualify as compliant with SOX, but would not create a strong indication of expertise on the committee that would be provided with at least one expert member. The high expertise scenario communicated that the audit committee contained an individual that is a CPA and former CFO of a mid-sized public company, and is considered an expert in both finance and accounting. This particular designation would meet and exceed the requirements that the committee contain an expert member.

The scenario for low audit committee member independence communicated that all members met the minimum requirements of SOX (i.e., were not compensated for other services other than the board, no material relationship with company, owning less than 10% of shares in the company). The low audit committee member independence scenario noted that the members

of the board owned an average of 8% of the outstanding shares of the company. The high independence scenario stated that all members were 100% independent, owning no shares of stock in the company.

Each scenario also contained a statement concerning ratings received by independent companies that track and evaluate the characteristics of audit committees. These ratings were either high (in the high expertise and high independence scenarios) or low (in the low expertise and low independence scenarios). These ratings were combined to create four separate groups, with each group receiving one combination of relevant facts related to the expertise and independence of the audit committee (high expertise/high independence, high expertise/low independence, low expertise/high independence, or low expertise/low independence). This information is commonly available to the public on various independent reporting websites, and was useful in the case to explain to the participants how the company's audit committee characteristics compare to generally accepted quality measures. See Appendix D for a copy of the scenarios described above.

After evaluating the circumstances of the case, the participants began the online survey questionnaire. First, they were asked to decide if the auditor is liable/not liable for negligence for their audit of the company. If the participant chose liable, they were asked to provide a number for suggested damages to be awarded to the plaintiff. After providing the initial assessment of liable/not liable and assessing damages, participants answered a series of questions designed to measure their overall perceptions of the four main constructs in the proposed model of the study: auditor liability, auditor independence, audit committee independence, and audit committee expertise. This series of questions provided multiple measures of the constructs included in the overall model to be tested in this study, as shown in Figure 2. The first page in this series of

questions asked participants to provide their perceptions about the liability of the auditor. Then, participants were asked to rate their perceptions of the independence of the auditor. Finally, they were asked to rate their perceptions of audit committee member expertise and independence. After completing this series of questions, participants were asked to provide demographic information and answer questions about their personal experiences that are commonly asked during the jury selection process. See Appendix D for a copy of this questionnaire.

Pre-Testing of Case and Questionnaire

The case study and questionnaire described above were edited based on feedback from multiple rounds of pre-testing before the final data was collected. First, the four versions of the case and questionnaire were examined by four lawyers, two business law professors, and ten individuals with expertise in accounting and/or auditing. After this round, edits were made to improve external validity (i.e., corrected legal terminology). Then, 22 individuals completed the entire task in paper format and provided direct feedback to the researcher concerning the understandability and overall impressions of the task. The edits made following this round primarily enhanced the clarity and added more focus on the manipulated facts in the case. Finally, an anonymous online pre-test was conducted with a sample of 52 individuals (11 jury eligible members of the community and 41 students in an undergraduate auditing course). These online pre-testers provided feedback about the technology and understandability of the case.

Based on the feedback from the final round of pre-testing, two significant improvements were made in the delivery format of the case. First, some pre-testers indicated that the audio levels on their computer were not functioning correctly, so the final online instrument provided an audio testing page at the beginning of the task with detailed directions on how to adjust the

audio levels of the participants' computer. The pre-test version of the case also provided a slideshow video of the text with audio, and participants were asked to read and listen to the case. However, some pre-testers experienced technology difficulties and indicated that they were not able to view the slideshow of the text. To reduce the likelihood of this particular technology issue occurring in the final data collection, the final online instrument provided the case within a text box on the page that allowed the participant to scroll down the page and read the text of the case while they listened to the audio recording.

The extensive pre-testing resulted in a low incidence of technological issues in the final data collection. 95.1% of the participants in the final sample responded that they had no issues with technology, with 97.1% indicating that they read the text, 89.2% indicating that they listened to the audio, and 86.4% of the participants indicating that they both read the text and listened to the audio. Individuals in the final sample also indicated that they enjoyed the task and found the task realistic and not overly difficult, reflected by their responses to questions that asked them to express their level of agreement (on a scale from one 'strongly agree' to seven 'strongly disagree' with the statements 'The task was difficult' (mean 4.322), 'The task was enjoyable' (mean 2.831), and 'The task was realistic' (mean 1.947).

Participants and Final Data Collection

The participants for this study represented jury eligible individuals. Potential participants were recruited by offering extra credit to undergraduate students for identifying jury-eligible individuals. These undergraduate students were given extra credit for providing contact information for up to five individuals (non-students) who agreed to volunteer to participate in the study as representatives of the community. The students were asked to specifically recruit people

who were over 18 years of age, were not accounting students, and were currently registered to vote in the U.S. Respondents to the survey were also asked to provide email contact information for other individuals interested in participating in the study. This data collection method allowed for a final sample of participants that was more likely to be representative of a potential jury pool, since members of the community that are jury eligible tend to make similar decisions to individuals who have actually served on a jury (Bornstein 1999).

Emails were sent to 1,487 jury eligible individuals inviting them to participate in the study. This email contained a direct link to the study and provided general details about the task they would be completing. The individuals were provided a period of two weeks to complete the task, and a follow-up email was sent to these individuals in the last week to remind them of the approaching end of the study period. A total of 247 unique entries to the online study were recorded resulting in a 17.9% overall response rate. Of these responses, 64 were not included in the final sample for failing to complete the entire task, and 43 were excluded for failing to correctly answer at least one of the manipulation check questions concerning the experience and stock ownership of the audit committee members. Finally, 24 individuals were excluded from the sample based on demographic characteristics or personal experiences that would be highly likely to disqualify them from serving on a jury in this type of trial (i.e., not a U.S. citizen, experience as an attorney, experience as an auditor, and experience as an audit committee member)¹¹. Overall, 116 responses were included in the final sample (7.8% usable response rate). The low overall response rate in this study was most likely due to the demanding nature of the task, which took participants an average of 33 minutes to complete, and the fact that

¹¹ These specific characteristics would most likely prevent them from serving on a jury in this type of case (Kadous, 2001).

participants did not receive compensation. To test for non-response bias, the mean responses from participants who completed the task in the second week of the study period (following the reminder email) were examined in comparison to others, with no differences found. Therefore, the low response rate is not likely to result in non-response bias.

All participants in the final sample provided answers to the demographic and jury selection questions shown in Appendix D. Responses were analyzed to determine if the results of the study would be influenced by personal characteristics by entering each as covariates in the analyses conducted in the study. Based on the results of this analysis, no significant demographic factors or individual characteristics emerged as having an influence on the variables measured in this study.

Table 20 provides details on the general demographics of the final sample. As shown in Panel A of Table 20, participants average age was 49 years old, and over 56% of the participants were female. Panel A of Table 20 also shows that 73.3% of the sample indicated that they have been called for jury duty (compared to national average of 65.0%). A total of 20.7% of the participants indicated that they have served on a jury (9.5% on a civil trial and 11.2% on a criminal trial), compared to national average of 37.4%. Panel B of Table 26 shows that 50.5% responded that they are registered Republicans, 33.0% are registered Democrats, 14.7% are registered Independent, and 1.8% are registered with other political parties. Panel C of Table 20 provides details on the employment of the participants. The majority of the participants indicated that they were currently employed on a full-time basis (51.7%), with 11.2% responding that they worked part-time, 7.8% were currently self-employed, 14.7% retired, 12.9% described themselves as a full-time homemaker, and 1.7% were currently unemployed. As shown in Panel D of Table 20, the income levels of participants were high on average, with 41.6% of the sample

indicating an annual household income of over \$100K. The participants also provided information about their highest education level, shown in Table 20 Panel E, with 6.1% only graduating high school, 3.5% attended a trade or professional school, 27.8% completed some college, 39.1% graduated college, 12.2% completed some graduate school, and 11.3% of the sample completed a graduate degree in college. 85.0% of the participants were white, 7.1% were Hispanic, 5.3% were African-American, and 1.8% were Asian or Pacific Islander. Over 85% of the participants listed Florida as their state of residence and all participants indicated that they are registered to vote.

Measurement, Scale Validation, and Descriptive Statistics

The proposed model for this study is tested using multiple measures of the participants' perceptions of the four constructs shown in Figure 2. The audit committee characteristics of expertise and independence were manipulated in a 2x2 between subjects design as represented in Table 19, and participants were asked to respond to a series of questions intended to measure the perceptions of each of the constructs in the model—audit committee independence, audit committee expertise, auditor independence, and auditor liability. These measures are used to test the proposed model. A follow-up analysis is conducted to test the between-subjects manipulation of these audit committee independence and audit committee expertise on both auditor independence and liability.

Because there were no pre-validated measures of every construct, questions were developed specifically for this study, and subjected to an extensive series of revisions before finalizing the questionnaire. Kadous (2000, 2001), Brandon and Mueller (2006, 2008), and Jennings et al. (2006) were utilized to develop a preliminary draft of the measures for this study.

Additional questions were also developed to provide multiple measures of each construct. After developing a preliminary draft of the questionnaire, the questions were reviewed by four lawyers, two business law professors, and ten individuals with expertise in accounting and/or auditing. Feedback was then used to improve external validity and reflect the correct legal terminology. The questionnaire was then tested with 22 individuals who provided detailed comments to the researcher concerning the understandability of the questions. Last, a pre-test of the questionnaire was conducted with 52 jury eligible individuals. The final draft of the questionnaire consisted of six questions to measure audit committee expertise, five questions to measure audit committee independence, five questions to measure auditor independence, and eight questions to measure auditor liability. Each of these questions is described in detail in the sections below.

Audit Committee Expertise Measurement and Validation

To measure perceptions of audit committee expertise, the participants were asked to express their agreement, on a scale from one (strongly disagree) to seven (strongly agree), with six statements concerning the audit committee members' qualifications and level of expertise during the audit in question. These measures were developed by the researcher based on the experience requirements of SOX, and were subjected to multiple rounds of pre-testing as described in the section above. Table 21 Panel A provides a summary of the mean responses to these questions for the low and high audit committee experience conditions. The mean responses to the statement that 'The audit committee had the relevant expertise for their job' were 2.509 for the 'Low AC Expertise' condition and 5.746 for the 'High AC Expertise' condition. The mean response to the statement that 'the audit committee had expertise in finance' for the 'Low AC

Expertise' condition was 2.018 and the mean for the 'High AC Expertise' condition was 5.763. For the statement that 'the audit committee had expertise in accounting', the mean response for the 'Low AC Expertise' condition was 1.965 and the mean for the 'High AC Expertise' condition was 5.695. The participants' mean response to the statement that 'the audit committee was able to comprehend the issues that arose during the audit' was 3.930 for the 'Low AC Expertise' condition, and 6.051 for the 'High AC Expertise' condition. The mean responses to the statement that 'the audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit' were 2.965 for the 'Low AC Expertise' condition and 5.847 for the 'High AC Expertise' condition. Finally, the mean responses for the statement that 'the audit committee's experience influenced the quality of the decisions made during the audit' were 4.807 for the 'Low AC Expertise' condition and 5.847 for the 'High AC Expertise' condition. An ANOVA of the mean responses to this series of questions indicates a significant difference between the responses from participants in the 'Low AC Expertise' conditions and the 'High AC Expertise' conditions for all questions ($p=0.001$). Overall, participants in the 'Low AC Expertise' conditions rated audit committee expertise significantly lower than the participants in the 'High AC Expertise' condition for each of these questions, indicating that the manipulation of audit committee expertise was successful in this study.

A principal components factor analysis was performed to test whether the individual measures of audit committee expertise described in the paragraph above loaded effectively on one factor. Results of the factor analysis are presented in Panel B of Table 21. All items loaded effectively on one factor (individual loadings were above 0.820), and 86.9% of the variance in the data was explained by this factor.

Audit Committee Independence Measurement and Validation

Perceptions of audit committee independence were measured based on the participants' agreement (on a scale from one (strongly agree) to seven (strongly disagree)) with five statements concerning the audit committee members' level of independence during the audit in question. These questions were developed based on measures of independence perceptions utilized in past research on auditor liability (Jennings et al., 2006; Brandon and Mueller, 2008). Table 22 Panel A provides a list of these questions, along with the mean response from participants in the low and high audit committee independence conditions. The participants' mean response to the statement that 'the audit committee members objective during the 2007 audit of Clovitech, Inc.' was 2.431 for the 'Low AC Independence' condition, and 4.524 for the 'High AC Independence' condition. The mean responses to the statement that 'the audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.' were 2.155 for the 'Low AC Independence' condition and 4.121 for the 'High AC Independence' condition. Participants also responded to the statement that 'management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management', with a mean response for the 'Low AC Independence' condition of 2.121 and 2.672 for the 'High AC Independence' condition. The mean responses to the statement that 'the audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.' were 1.914 for the 'Low AC Independence' condition and 3.448 for the 'High AC Independence' condition. Finally, mean responses for the statement that 'the audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management' were 2.121 for the 'Low AC Independence' condition and 4.034 for the 'High AC Independence' condition. An ANOVA of the mean

responses to these questions indicates that participants' responses to each question in the 'Low AC Independence' conditions were significantly different compared to participants' responses in the 'High AC Independence' conditions ($p < 0.001$). Overall, a comparison of the mean responses to each question shows that participants in the 'Low AC Independence' conditions consistently rated audit committee expertise significantly lower than the participants in the 'High AC Independence' condition, indicating that the manipulation of audit committee independence was successful in this study.

A principal components factor analysis was performed on these five items to determine whether all load effectively on one factor to represent audit committee independence. The first factor analysis indicated that one item, responses to the statement that 'management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management', exhibited low loading on the factor (0.350) and was eliminated from the scale. The final analysis indicated that all of the remaining four items loaded effectively on one factor with individual loadings above 0.825, explaining 75.1% of the variance in the data. Results of this factor analysis are presented in Panel B of Table 22.

Auditor Independence Measurement and Validation

Perceptions of auditor independence were measured based on the participants' agreement (on a scale from one= strongly agree to seven= strongly disagree) with five statements that 'ABC CPA Firm was objective during the 2007 audit of Clovitech, Inc', 'ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.', 'management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management', 'ABC CPA Firm's decisions during the audit were influenced by the managers of

Clovitech, Inc.’ and ‘ABC CPA Firm was protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management’. These questions were developed based on measures utilized in past research on perceptions of auditor independence and auditor liability (Jennings et al., 2006; Brandon and Mueller, 2008), with additional questions developed by the researcher. A summary of the mean responses to these questions by experimental condition can be found in Table 23, Panel A. An ANOVA of the mean responses to each question indicates significant differences between groups for each of the individual measures of auditor independence ($p < 0.05$) except for the question stating ‘management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management.’

A principal components factor analysis was performed on responses to the questions described above, with results reported in Panel B of Table 23. The first factor analysis indicated that one item, responses to the statement that ‘management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management’ did not load effectively on the factor (individual loading was 0.550), so this item was dropped from the final analysis. The final analysis indicated that the four of the remaining items loaded effectively on one factor (all individual loadings were above 0.733). This factor explained 67.6% of the variance in the data. This factor analysis was used to construct a single measure of auditor independence, which is further examined in the additional analysis section of the study.

Auditor Liability Measurement and Validation

As a measure of auditor liability perceptions, participants were asked to respond to a series of five questions representing their opinions on the degree of auditor liability in the case.

The responses to these five questions represent measures of the auditor liability construct tested in the main model of this study. These questions were developed based on past research on jurors' assessments of auditor liability (Kadous 2000, 2001; Brandon and Mueller 2006, 2008), with additional questions added by the researcher to provide multiple measures of auditor liability. A summary of the mean responses to these questions by experimental condition can be found in Panel A of Table 24. Participants were asked to express their level of agreement (from one (strongly agree) to seven (strongly disagree) with the statements that the auditor '... is liable for negligent misrepresentation', '... performed their services in compliance within the standards that dictate how audits should be performed', '... made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose', '... could have prevented the stockholder losses' and '... is responsible for stockholder losses.' Results of an ANOVA indicate significant differences between the means of all groups for the questions asking whether the auditor is liable for negligent misrepresentation, whether the auditor made appropriate disclosures, and whether the auditor could have prevented shareholder losses ($p < 0.05$). Further analysis of the mean responses per condition indicates that the auditor in the Low Independence/High Expertise condition is rated the least favorable compared to the other conditions.

Panel B of Table 24 reports the results of a principal components factor analysis with responses to the questions described above. Results of the factor analysis indicate that all items load effectively on one factor, with individual loadings all above 0.773. This factor explained 67.9% of the variance in the data.

Participants were also asked to decide whether the auditor is 'Liable' or 'Not Liable' for negligent misrepresentation, which has often been used in past research to measure auditor

liability (Kadous 2001; Brandon and Mueller 2006, 2008), Since this measure is dichotomous, the responses to this question are tested in the additional analysis section of the study, and the measure is not included in the main model. Panel C of Table 24 provides a summary of the responses to this question by experimental condition. Overall, 50.9% of the participants responded 'Liable'. Further examination of the differences between groups indicates that the mean response from participants in both conditions reflecting a low independence level for the audit committee was 'Liable', compared to the participants in the high independence conditions reporting 'Not Liable' on average ($p=0.041$). However, no significant differences between the mean responses exist between the conditions based on audit committee expertise ($p=0.997$).

Participants were also asked to assess separately compensatory and punitive damages. These questions were developed based on past research on auditor liability (Brandon and Mueller 2006, 2008). Compensatory and punitive damages were measured by first providing a brief description of the definition of each type of damages, and then asking the individual to enter a number between \$0 and \$100,000,000 for compensatory damages and between \$0 and \$200,000,000 for punitive damages. The responses to these two questions are tested in the additional analysis section of the study, and are not included in the main model. Panel B of Table 24 provides a summary of the responses to this question by experimental condition (in millions). For this analysis of the mean responses, participants who responded that the auditor was 'Not Liable' were entered as \$0 for compensatory and punitive damages, since a no liable judgment would indicate zero damages assessed against the auditor. Examination of the differences between groups indicates that the mean response from participants for punitive damages is significantly different between the high expertise/low independence group and all other groups ($p=0.03$). This group reported the highest mean compensatory damages (\$3.745 million)

compared to all other groups. The low expertise/low independence group reported the second highest compensatory damages (\$3.435 million), followed by the low expertise/high independence group (\$2.643), and the high expertise/high independence group (\$2.420 million). Examination of the differences between groups also indicates that the mean response from participants for punitive damages is significantly different between all conditions ($p < 0.02$). On average, the high expertise/high independence group reported the lowest punitive damage awards (\$1.503 million), and the high expertise/low independence group reported the highest punitive damages (\$5.610 million). The low expertise/low independence group reported the second highest punitive damages (\$2.628 million), followed by the low expertise/high independence group (\$2.329 million).

Results

PLS Model Results

The proposed model was tested using PLS latent variable modeling with a bootstrap resampling of 1000 (Ringle et al., 2005; Chin 2010). Table 25, Panel A provides a summary of the factor loadings for each item. One item for each of the Audit Committee Independence and Auditor Independence factors exhibited a loading of less than 0.70, both of which related to whether the audit committee/auditor was pressured by management¹². These two items were also noted as having low loadings in the factor analysis presented above. Based on the low loadings, these two items were dropped from the PLS analysis. All other factor loadings in the final model

¹² Although these questions ask whether the auditor or auditor committee were pressured by management, the questions did not ask whether the auditor was influenced by this pressure, which could explain why the measure did not load effectively.

were above 0.700, within the range of 0.736-0.968, which provides support for convergent validity (Chin, 2010). Discriminant validity, which establishes that each variable in the model is different, is also evidenced by the fact that the average variance extracted for each latent variable is greater than the squared inter-construct correlations. Further, the inter-construct correlations are all below 0.850, as shown in Table 25, Panels B and C. Panel D of Table 25 shows the item loadings and cross-loadings for all latent variable measures, and indicates that no items load higher on other constructs compared to the intended construct. Overall, the convergent and discriminant validity of the constructs is supported by these results (Chin, 2010).

The overall model results are shown in Figure 3, along with the standardized coefficients, t-values, and r-squared values for each construct. The r-squared values indicate that the model has strong explanatory power, as 40.7% of the variance in auditor independence perceptions is explained by perceptions of audit committee expertise and independence, and 54.7% of the variance in auditor liability is explained by perceptions of auditor independence. H1, which predicted a positive relationship between perceptions of audit committee expertise and auditor independence was not supported ($\beta=-0.075$, $t\text{-value}=0.477$, $p=0.513$). However, H2, which predicted a positive relationship between perceptions of audit committee independence and auditor independence was supported ($\beta=0.507$, $t\text{-value}=2.709$, $p<0.001$). H3, which predicted that jurors would perceive the auditor as more independent when they perceive the audit committee to be more independent and expert, was not supported ($\beta=0.144$, $t\text{-value}=0.600$, $p=0.549$). Finally, H4, which predicted that lower (higher) perceptions of auditor independence would lead to higher (lower) auditor liability, was supported ($\beta=-0.740$, $t\text{-value}=19.289$, $p<0.001$).

Additional Model Tests and Results

Since the results of this study do not appear to support H1 or H3, indicating that audit committee expertise and the interaction between audit committee expertise and audit committee independence do not significantly influence perceptions of auditor independence, a follow-up analysis was performed to examine whether these variables directly influence auditor liability. This second model included all paths in the first model, with direct paths to Auditor Liability added from Audit Committee Independence, Audit Committee Expertise, and Audit Committee Expertise x Audit Committee Independence. Figure 4 reports the overall results of the PLS analysis of this model. All significant paths in the first model remained significant in this model, and all r-squared values were comparable to the first model, maintaining support for H2 and H4. The additional path tested between the interaction of Audit Committee Expertise and Audit Committee Independence is also significant and negative, supporting a direct relationship between audit committee characteristics and auditor liability exposure. This result supports the descriptive findings shown in Panel A of Table 24, which shows that the mean responses for participants' ratings of auditor liability are lower for the High Expertise/High Independence condition for three of the questions. Overall, the results of this model suggest that auditor liability may be directly influenced by the interaction of audit committee independence and expertise, and indirectly influenced by audit committee independence (through auditor independence). Further discussion of the implications of these results continues in the conclusion section.

Additional Analyses: H1-H4 and Follow-Up Analyses

The following sections provide additional analyses of H1-H4. First, H1-H3 are tested to examine whether the between-subjects manipulations in this study (audit committee

independence and audit committee expertise) influenced perceptions of auditor liability. Then, H4 is tested with auditor liability measured as participants' liable/not liable judgments and assessments of compensatory and punitive damages, which were not designed to be tested in the overall model. Overall, the analyses below provide support for the results presented in the PLS models, with some additional insights.

H1-H3: Audit Committee Expertise, Audit Committee Independence, and Auditor Independence

H1 predicted that auditors will be perceived as more independent when the audit committee members have higher levels of expertise. H2 predicted that when audit committee members are more independent, auditors will be perceived as more independent. H3 predicted that audit committees with high levels of both expertise and independence will result higher auditor independence perceptions compared to all other conditions. In the first additional test of these hypotheses, an analysis of the variance (ANOVA) is conducted with the independent variables Audit Committee Expertise (H1), Audit Committee Independence (H2), and Audit Committee Independence x Audit Committee Expertise (H3). Results of this analysis are reported in Table 26 Panel A. Audit Committee Expertise and Audit Committee Independence for this first analysis are each represented by the manipulation of these variables. The dependent variable in this analysis was Auditor Independence represented by the factor score of participants' responses to the series of questions on auditor independence that were included in the tests of the overall model. Results are significant overall, $F(3,116) = 6.275, p=0.001$, and indicate that Audit Committee Independence significantly influenced perceptions of auditor independence ($p=0.001$). However, Audit Committee Expertise and the interaction between Audit Committee Independence and Audit Committee Expertise were not statistically significant

($p=0.443$ and 0.267 accordingly). Examination of the mean factor scores for auditor independence in Table 26 Panel B indicates that the participants in the high audit committee independence experimental conditions perceived auditors to be more independent compared to participants in the low audit committee independence conditions, which supports H2. Results of this test do not support H1 (influence of audit committee expertise on auditor independence) and H3 (influence of audit committee expertise x audit committee independence on auditor independence).

Overall, the results of these additional tests provide support for H2 by suggesting that jurors perceive auditors as more independent when audit committee independence is high. However, the results do not support H1 or H3, suggesting that perceptions of auditor independence may not be influenced by audit committee expertise or the interaction between audit committee expertise and independence. These results are consistent with the findings in the tests of the proposed model for this study.

H4: Perceptions of Auditor Independence and Auditor Liability

Hypothesis 4 predicted an inverse relationship between perceptions of auditor independence and auditor liability, such that higher perceptions of auditor independence would be associated with lower auditor liability. This hypothesis is further tested in three separate analyses, based on three different measures of the dependent variable Auditor Liability. The first analysis examines the ‘liable’ vs. ‘not liable’ decision reached by the participant in a logistic regression model. Then, participants’ assessments of compensatory and punitive damages are tested in two regression models. The independent variable in all analyses is represented by the factor score for perceptions of auditor independence.

A logistic regression analysis was performed first to examine the influence of perceptions of auditor independence, represented by factor scores, on auditor liability measured as a dichotomous variable representing participants' liable/not liable judgments. Results reported for logistic regression include an odds ratio and a percentage estimate of how often the model successfully predicts the dependent variable. The proposed model is accepted when it is significant and provides an improvement over the intercept-only model, specifically when the Nagelkerke r-squared and percentage predictions are higher in the proposed model. As shown in Panel A of Table 27, a test of the proposed model in comparison to the intercept-only model (excluding the independent variable) was statistically significant, $\chi^2(1, N = 116) = 43.141$, $p=0.001$, Nagelkerke $R^2 = 0.446$. Overall, this model predicted the outcome of 'Not Liable' 76.4% of the time and the outcome of 'Liable' 75.5% of the time, with an overall successful prediction rate of 76.4%. The independent variable Auditor Independence was significant in the model ($p=0.001$), indicating that individuals with higher perceptions of auditor independence were less likely to find the auditor liable. This result supports H4, which proposed that jurors will evaluate auditors more favorably when they perceive the auditor to be independent.

The next analysis to test H4 was performed by examining the measures for compensatory and punitive damages in separate regression models. This analysis was performed only on the individuals who reported that the auditor is 'Liable', which would be the most realistic representation of a jury decision since only those cases finding the auditor liable would decide on damages. This sub-sample consists of 59 participants (50.9% of the total sample). The dependent variable in each model is measured by the dollar amount of damages (in millions), and the independent variable is represented by the factor score for auditor independence perceptions. As shown in Panels B and C of Table 27, both models are significant ($p=0.001$) and indicate that

perceptions of auditor independence are inversely related to the dollar amount of damages against the auditor for both compensatory and punitive damages. These results provide additional support for H4, indicating that higher perceptions of auditor independence are associated with lower damage awards (more favorable for the auditor).

In conclusion, additional analyses indicate that H4 is supported for all measures of auditor liability, including the participants' liable/not liable decision, the award of punitive and compensatory damages, and perceptions of auditor liability. Overall, these results indicate that auditor independence can favorably influence the outcome of a trial by decreasing the likelihood of a liable verdict, lowering the exposure to monetary losses, and favorably influencing the overall perceptions of the auditor's liability for losses.

Summary of Additional Analyses

To summarize the results from the additional analysis, all tests provide support for the findings in the PLS analysis. H1, which predicted that audit committee expertise directly influences perceptions of auditor independence, was not supported in any of the analyses in this study. All tests in the study support H2, including the PLS model, tests of the auditor's liable/not liable judgments, and tests of participants' assessment of punitive and compensatory damages. Therefore, H2, which predicted that audit committee independence directly influences perceptions of auditor independence, is strongly supported in this study. The interaction effect between audit committee independence and audit committee expertise on auditor liability (H3) was not supported in any of the tests. H4 was consistently supported for all tests, indicating that perceptions of auditor independence significantly influences auditor liability measured by participants' liable/not liable judgments, participants assessment of punitive and compensatory

damages, and responses to a series of questions measuring their perceptions of auditor liability. The overall implications of these findings are discussed in the conclusions section below.

Conclusion

Overall, the test of the proposed model and follow-up analyses of the individual hypotheses proposed in this study provide support for significant links between audit committee independence and auditor independence (H2), and between auditor independence and auditor liability (H4). These results suggest that perceptions of audit committee independence can have a significant influence on perceptions of auditor independence, such that when the audit committee is deemed more/less independent the auditor is similarly perceived. More importantly, perceptions of auditor independence significantly influence jurors' auditor liability judgments. When auditors were perceived as less independent, they were more likely to be assessed negatively by jurors evaluating whether the auditor should be held liable, assessing compensatory and punitive damages, and evaluating the degree of responsibility of the auditor for shareholder losses.

Although results do not suggest that perceptions of audit committee expertise influence perceptions of auditor independence (H1), an alternative model indicates that the interaction between audit committee expertise and audit committee independence have a significant direct influence on auditor liability exposure. Overall, auditors are evaluated most favorably when audit committees contain members with higher levels of both expertise and independence. However, further examination of the descriptive statistics for the mean responses to participants' evaluation of auditor liability reveals that auditors are evaluated the least favorable overall when audit committees contain high levels of expertise and low levels of independence, even when

compared to committees with low levels of both expertise and independence. This finding indicates that audit committee expertise can directly influence auditor liability exposure, but that this influence is only favorable for the auditor when the audit committee members are also independent. The implications of this particular finding are important, as the addition of an expert member on a client's audit committee may not be positive for auditors if this member also has a financial stake in the company. Auditors may experience the most favorable liability exposure conditions if the expert audit committee members are restricted from direct stock ownership in the company. Future research in this area could examine audit committee liability exposure given these factors to determine whether there is an additional incentive to creating audit committees with high levels of independence and expertise.

Results of this study are limited by many factors that are common to survey research. First, the participants reviewed a case that was not real or in a realistic setting (i.e., a courtroom), which decreases the external validity of the task. In addition, participants completed the task in an online setting, which did not allow the researcher to observe the participant completing the task. Therefore, measurements of time spent on the task may not be accurate, as the participants may have been interrupted or completing other tasks while the case was open. The results of this study are also limited by the potential for measurement error, which increases the risk that the results are not fully reflective of the participants' perceptions about auditor liability. This potential for measurement error was addressed in this study by asking multiple questions to measure each construct, but some error is likely to remain in the measurements included in this study. The survey was also limited in length due to the demanding nature of the task and the fact that responses were voluntary; and, although the researcher collected demographic and background data on each participant, additional factors not measured in the questionnaire could

influence the results of the study. Finally, although the participants were representative of jury eligible individuals, they were not participants in an actual court case, and did not undergo the jury selection process that would normally occur before a trial. Future research in this area could accommodate for these weaknesses by collecting data in person, simulating a trial live using actors, and asking lawyers with expertise in this area to participate in a simulated jury selection process, all of which would increase external validity of the results.

This study provides insight into how specific characteristics of audit committee members, independence and expertise, influence jurors' perceptions of auditor independence and judgments of liability following an audit failure. Corporate governance has been shown to impact judges' perceptions of auditors, but past research only examined the overall quality of corporate governance and did not examine the influence of audit committee expertise and independence on perceptions of auditors (Jennings et al., 2006). These individual audit committee characteristics are important to understand in the current environment, as audit committees remain somewhat varied in the level of expertise and independence of their members. Since auditor liability exposure can be influenced by the perceptions of the conditions under which they conducted the audit, these characteristics can prove to be important for understanding auditor liability exposure in a Post-SOX audit environment. Auditors will be able to use the results from this study to make informed decisions about which clients expose them to the least amount of liability in the event of an audit failure, which could prove useful for audit firms who are currently facing an increased threat of litigation. Overall, this study suggests that ownership of stock in the company by audit committee members can increase auditor liability exposure, particularly when the audit committee contains high levels of expertise. These results indicate that auditors may wish to pay

close attention to the expertise and stock ownership of audit committee members when evaluating engagement risk.

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GENERAL CONCLUSION

The three studies presented in this dissertation examined how different factors related to provisions of The Sarbanes-Oxley Act of 2002 (SOX) impact the litigation and legal liability exposure of auditors. Study one examined whether SOX Section 404 disclosures on internal controls influence the likelihood that the auditor will be sued for negligence. Study two extended the first study by assuming a company's auditor has been sued for negligence following the company's bankruptcy, and examined jurors' perceptions of the auditor's liability in a trial setting. Study three further investigated juror's perceptions of auditors in a trial setting, specifically examining how the characteristics of the client's audit committee influence jurors' perceptions of auditor independence and liability. Results from each of these studies provide unique contributions to theory and practice, discussed in more detail in the paragraphs below.

Results from study one provide important insights into how the auditor's Section 404 reporting decisions influence the likelihood of being sued when a client declares bankruptcy. Results indicate that auditors may be able to decrease their litigation exposure by reporting an adverse opinion on internal controls when they discover internal control issues within a company. These results suggest that an adverse Section 404 report may be able to provide signals of the potential risks of material misstatements in the financial statements, even when the auditor still reports an unqualified opinion on the financial statements. However, results did not support the use of voluntary disclosures of a significant deficiency in internal controls within an unqualified Section 404 report as a significant influencing factor on litigation exposure. Therefore, the stronger signal of an adverse opinion on internal controls may provide a signal of risk to stakeholders of the potential for material misstatements in the financial statements.

However, although auditors reporting an adverse opinion on internal controls are exposed to lower likelihood of litigation when compared to auditors reporting an unqualified opinion on internal controls, auditors were still exposed to a high likelihood of being sued overall. This result suggests that the auditor's Section 404 report may not be able to reduce the likelihood that the auditor will be sued when a client declares bankruptcy.

Study one results also provide interesting insights about audit committee and management litigation exposure under different Section 404 reporting conditions. Management appears to be exposed to the most liability in all circumstances, which indicates that management is perceived as having the primary responsibility for accurate financial reporting. However, the audit committee's litigation exposure differs by the content of the auditor's Section 404 report, such that the committee is exposed to the greatest likelihood of litigation when the auditor reports an unqualified opinion on internal controls with a voluntary disclosure of a significant deficiency. This result could suggest that litigators believe that the auditor should have reported an adverse Section 404 opinion after uncovering the issues in internal controls within the company, and that these litigators are placing blame on the audit committee for this lack of oversight.

Results of study two suggest that auditors are most favorably evaluated by jurors in a trial setting when the circumstances of the case suggest that the auditor mistakenly evaluated a more auditable internal control, and provided a voluntary disclosure of the risks related to this control. Finding that the auditability of the internal control in question significantly influences the liability exposure of auditors is important, since auditors are often faced with significant variances in the amount of evidence they can collect to evaluate certain internal controls. The results suggest that when auditors are able to show evidence to support their conclusions, and

provide disclosures of their findings, they will be evaluated the most favorably in a trial setting. In contrast, when auditors are not able to show significant evidence supporting a highly subjective judgment, such as when they evaluate management's integrity, jurors evaluate them less favorably in a trial setting. Therefore, the study provides practical insights for the current debate regarding the liability exposure for auditors following SOX by suggesting that auditors can potentially lessen their liability exposure by increasing the transparency of their Section 404 reports. Since voluntarily disclosing significant deficiencies in less auditable internal controls does not appear to decrease their liability exposure to the same extent as disclosing more auditable deficiencies, auditors may wish to evaluate the less auditable deficiencies more closely or report an adverse opinion on internal controls whenever such deficiencies are found.

Study three provides support for the auditor's consideration of the characteristics of a client's audit committee when assessing the engagement risk of an audit. Results of this study suggest that audit committee independence and expertise significantly influence the liability exposure of auditors in a trial setting. Specifically, audit committee independence influences jurors' perceptions of auditor independence, which in turn influences how auditors are evaluated in the trial. This finding suggests that auditors should evaluate the level of independence of audit committee members for each client, since this factor may significantly influence how they are perceived in the event of litigation. In addition, the results show that audit committee expertise and independence may interact to directly influence auditor liability exposure, such that audit committees with high levels of independence and expertise result in the most favorable liability conditions for the auditor. Interestingly, when audit committees contain members with high levels of expertise and low levels of independence, the auditor is evaluated the least favorable overall. These results suggest that auditors should pay close attention to the expertise and

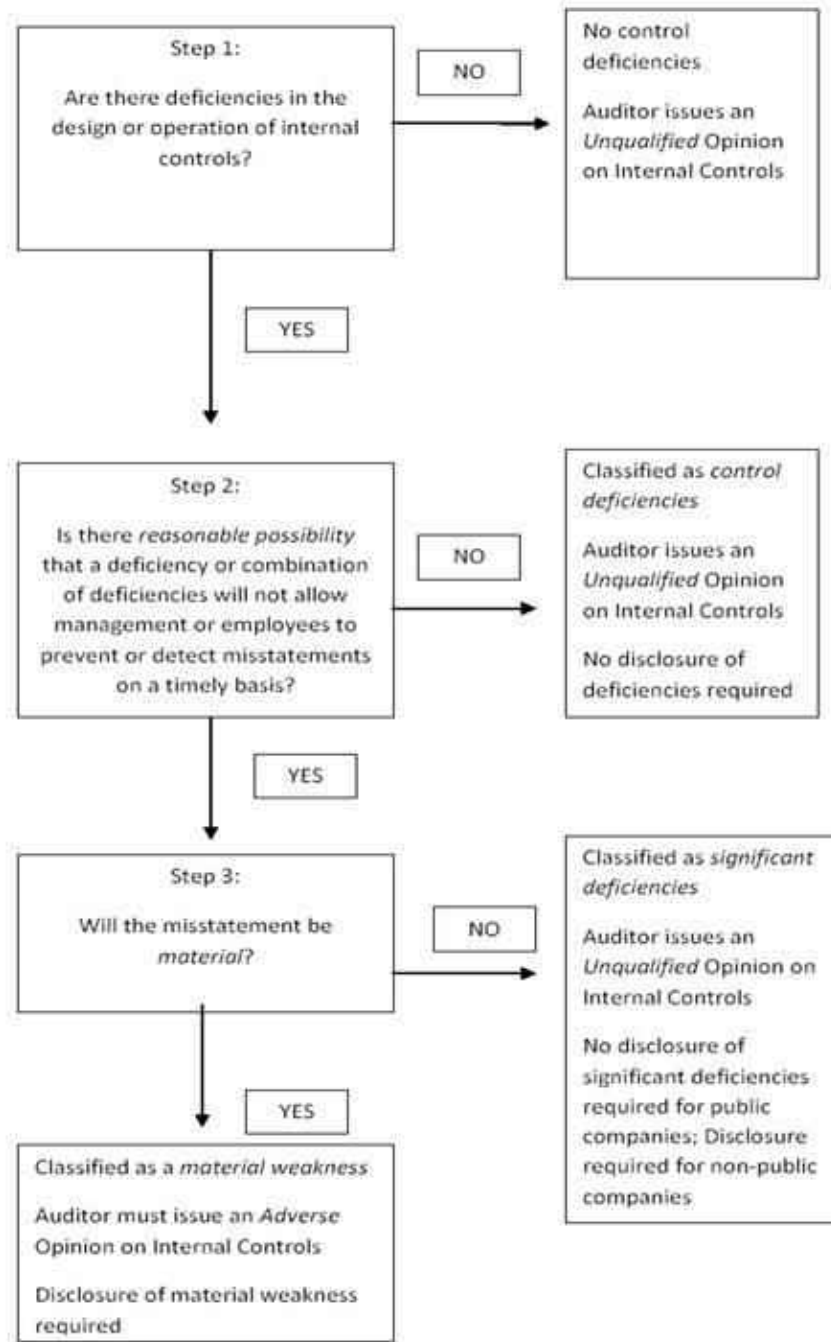
independence levels of audit committees, since the wrong combination of these two characteristics may produce unfavorable conditions in the event of a trial implicating the auditor.

In summary, the results of all three studies indicate that auditors may be able to reduce their litigation and liability risks by providing adequate signals to stakeholders of risks, paying close attention to the amount of evidence they rely upon when making decisions, and carefully considering the characteristics of their client's audit committee. These important factors may be considered at different phases in the liability/litigation assessment process. First, auditors perform an evaluation of liability risks associated with their new and ongoing clients at the planning phase of every audit. Auditors may utilize the results of this study in developing proper assessments of risks based on the characteristics of the audit committee. They may also decide to carefully plan procedures for their audit of internal controls based on the potential legal liability risks associated with the different types of internal controls to be evaluated. Then, at the end of the audit, the auditor may be able to utilize the results of this study when determining the content of their Section 404 report on internal controls. Finally, should the auditor be involved with a client that declares bankruptcy or experiences a significant downturn in the market, results of this study could provide insights to assist with the assessment of the likelihood that they will be found liable in a trial setting, which could be considered important when deciding on settlement values or trial strategies. These implications are broad and could be highly useful to auditors in practice.

Overall, auditors' continued exposure to legal liability provides an opportunity for researchers to provide valuable contributions to practice. Future research could expand on the findings of these three studies by examining how judges perceived auditors in similar contexts, which would provide additional insight into the legal liability exposure of auditors in the event of

a bench trial. Future research could also be conducted by staging a live simulated trial, which would provide a more realistic setting and increase external validity. Results could also be expanded by allowing jurors to deliberate in groups to determine the verdict. Extending this line of research could assist auditors in improving their ability to assess audit risk at the planning stage of the audit and provide insights for litigation strategy in the event of a lawsuit against the auditor.

APPENDIX A: FIGURES AND TABLES



Created based on the PCAOB standards and implementation guidance in AS-5 (PCAOB, 2007)

Figure 1: Decision Processes for the Auditor’s Report on Internal Controls

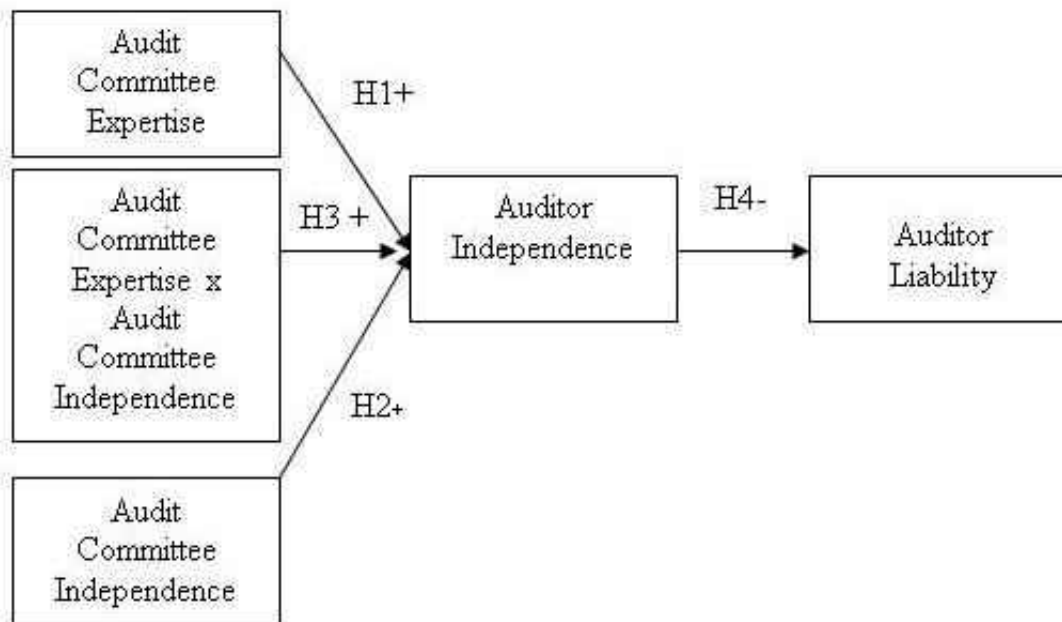
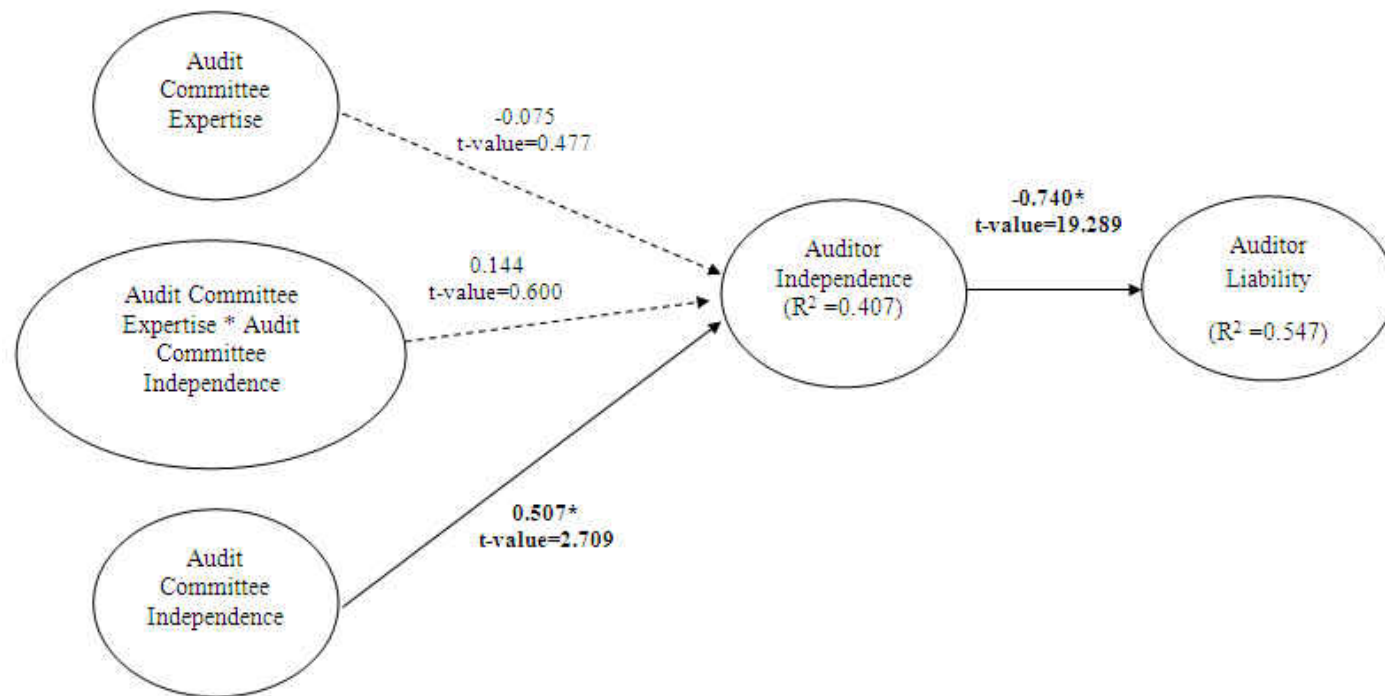
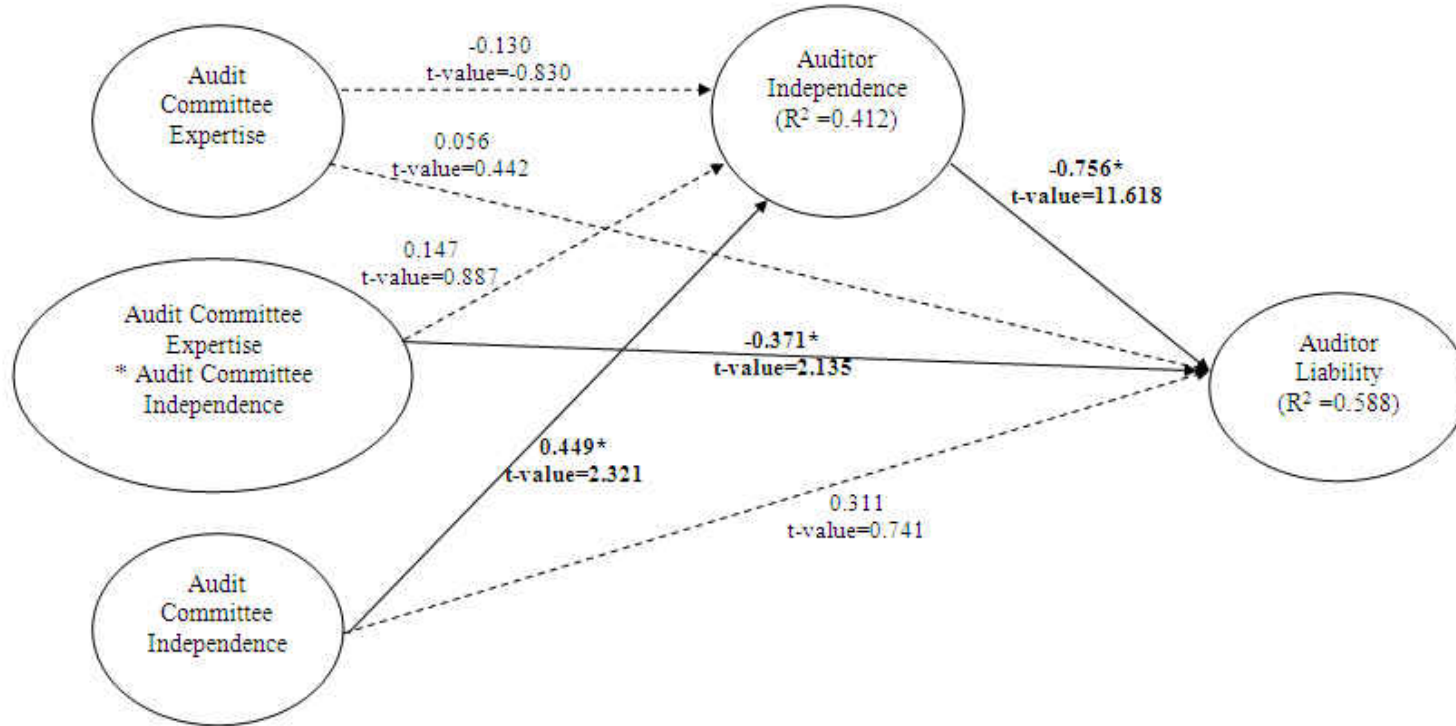


Figure 2: Proposed Research Model of Jurors' Perceptions of Audit Committee Expertise, Audit Committee Independence, Auditor Independence and Auditor Liability



*Path is significant at $p < 0.001$

Figure 3: Predicted PLS Model Results



*Path is significant at $p < 0.05$

Figure 4: Additional PLS Model Results

Table 1: Overview of Research Methodology Examining the Effect of the Auditor’s Report on Internal Controls on Potential Litigators’ Evaluation of Auditor Liability

<i>The Auditor’s Report on Internal Controls (3 x 1 Design)*</i>		
Unqualified Opinion on Internal Controls with no Disclosure of Significant Deficiency	Unqualified Opinion on Internal Controls with Voluntary Disclosure of Significant Deficiency	Adverse Opinion on Internal Controls with Disclosure of Material Weakness
(Cell 1)	(Cell 2)	(Cell 3)
N=33	N=30	N=37

H1: Auditors reporting an *unqualified* opinion on internal controls *containing voluntary disclosures of control deficiencies* will be evaluated *more favorably* than auditors reporting an *unqualified* opinion on internal controls with *no additional disclosures*. [(Cell 1 compared to Cell 2)]

H2: Auditors reporting an *adverse opinion* on internal controls will be evaluated *more favorably* by potential litigators than auditors reporting an *unqualified* opinion on internal controls *containing voluntary disclosures of control deficiencies* or an *unqualified* opinion on internal controls with *no additional disclosures* [(Cells 1 and 2 compared to Cell 3)]

*Note: Participants in this study were lawyers who specialize in business law, bankruptcy law, and/or securities law.

Table 2: Demographic Information

Group*	N	Mean	Age				Gender		Degree	
			Under 25	25-44	45-64	65+	Male	Female	Graduate Law Degree	Business Degree
1	33	55	0.0%	12.1%	69.7%	18.2%	90.6%	9.4%	100.0%	15.2%
2	30	54	0.0%	20.7%	69.0%	10.3%	93.1%	6.9%	100.0%	27.6%
3	37	52	0.0%	24.3%	62.2%	13.5%	91.7%	8.3%	100.0%	24.3%
Overall	100	54	0.0%	19.2%	66.7%	14.1%	91.8%	8.2%	100.0%	22.2%

**404 Reporting Condition groups are as follows: 1=Unqualified opinion with no disclosure, 2=Unqualified opinion with disclosure, 3=Adverse opinion*

Table 3: Participant Experience and Specialization Characteristics

Panel 1: Specialization

Group*	Percentage Time Spent on Legal Matters (Means)			Percentage of Individuals with Study-Related Specialty *						
	Civil	Criminal	Other	Bankruptcy Law	Business Law	Class Actions	Professional Liability	Securities Law	Torts	Other
1	47.1%	3.3%	63.8%	6.1%	78.8%	30.3%	15.2%	84.8%	15.2%	9.1%
2	53.8%	7.3%	56.7%	0.0%	69.0%	34.5%	27.6%	82.8%	27.6%	20.7%
3	51.0%	0.9%	63.1%	8.1%	78.4%	32.4%	16.2%	78.4%	16.2%	13.5%
Overall	50.6%	3.7%	61.6%	5.1%	75.8%	32.3%	19.2%	81.8%	19.2%	14.1%

*Note: All participants in the study selected at least one study-related specialty

Panel 2: Experience

Group*	Knowledge Securities Litigation**	Experience Securities Litigation**	Percent of Individuals with Experience on Auditor Liability Case				Percent of Individuals with Business-Related Experience			
			Any Experience	Defense Team	Plaintiff Team	Other	CPA	Auditor	Manager	Audit Committee
1	5.909	4.688	54.5%	24.2%	33.3%	3.0%	3.0%	0.0%	3.0%	12.1%
2	5.862	4.862	51.7%	27.6%	27.6%	13.8%	3.4%	3.4%	10.3%	3.4%
3	5.595	4.919	54.1%	18.9%	24.3%	13.5%	0.0%	0.0%	16.2%	2.7%
Overall	5.778	4.827	53.5%	23.2%	28.3%	10.1%	2.0%	1.0%	10.1%	6.1%

*404 Reporting Condition groups are as follows: 1=Unqualified opinion with no disclosure, 2=Unqualified opinion with disclosure, 3=Adverse opinion

**Measured on a scale from 1-7, with 7 indicating the highest level of knowledge and experience

Table 4: Measurement of Auditor Litigation Exposure Dependent Variable

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding Within Specified Range				
				< 50	50-69	70-89	90 - 99	100
What is the likelihood (from 0 to 100%) that a lawsuit will be filed against the auditor?	1	84.848	26.025	12.1%	6.1%	9.1%	18.2%	54.5%
	2	88.167	14.884	0.0%	6.7%	23.3%	26.7%	43.3%
	3	74.054	29.810	16.2%	13.5%	21.6%	16.2%	32.4%
	Overall	81.850	25.392	9.4%	8.7%	18.0%	20.4%	43.4%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1) Extremely Weak Case	Somewhat Weak	Slightly Weak	Neither Strong or Weak	Slightly Strong	Somewhat Strong	(7) Extremely Strong Case
Please indicate your opinions about the strength of a potential case against the auditor.	1	5.636	1.475	0.0%	6.1%	6.1%	9.1%	6.1%	42.4%	30.3%
	2	5.333	1.626	0.0%	10.0%	10.0%	0.0%	23.3%	30.0%	26.7%
	3	4.703	1.596	2.7%	5.4%	21.6%	8.1%	24.3%	27.0%	10.8%
	Overall	5.200	1.602	1.0%	7.0%	13.0%	6.0%	18.0%	33.0%	22.0%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1) Strongly Disagree	Somewhat Disagree	Slightly Disagree	Neither Agree or Disagree	Slightly Agree	Somewhat Agree	(7) Strongly Agree
I would advise stockholders to file a lawsuit against the auditors.	1	6.091	1.331	0.0%	3.0%	0.0%	15.2%	6.1%	18.2%	57.6%
	2	6.100	1.447	0.0%	3.3%	10.0%	0.0%	3.3%	26.7%	56.7%
	3	5.000	1.929	5.4%	13.5%	2.7%	8.1%	24.3%	16.2%	29.7%
	Overall	5.690	1.680	2.0%	7.0%	4.0%	8.0%	12.0%	20.0%	47.0%

*404 Reporting Condition groups are as follows: 1=Unqualified opinion with no disclosure, 2=Unqualified opinion with disclosure, 3=Adverse opinion

Table 5: Analysis of Auditor Litigation Exposure Dependent Variable

Panel 1A: MANOVA of Auditor Litigation Exposure for H1

Variable	Wilks' Lambda	F-Statistic	P-Value (one-tailed)	Partial Eta Squared
404 Report	0.941	1.244	0.151	0.059

Dependent Variable = Three Measures of Auditor Litigation Exposure (likelihood of being sued, strength of case against auditor, auditor lawsuit recommended)

Panel 1B: Separate ANOVAs of Auditor Litigation Exposure Measures for H1

Question	Mean (by 404 Report Condition)		F-Score	P-Value (one-tailed)
	Group 1: Unqualified/ No Disclosure	Group 2: Unqualified/ Disclosure		
Likelihood of Lawsuit against Auditor	84.8	88.2	0.376	0.271
Strength of Case against Auditor	5.636	5.333	0.602	0.221
Auditor Lawsuit Recommended	6.090	6.100	0.001	0.490

Panel 2A: MANOVA of Auditor Litigation Exposure for H2

Variable	Wilks' Lambda	F-Statistic	P-Value (one-tailed)	Partial Eta Squared
404 Report	0.868	2.319	0.035	0.068

Dependent Variable = Three Measures of Auditor Litigation Exposure (likelihood of being sued, strength of case against auditor, auditor lawsuit recommended)

Panel 2B: Separate ANOVAs of Auditor Litigation Exposure Measures for H2

Question	Mean (by 404 Report Condition)			F-Score	P-Value (two-tailed)
	Group 1: Unqualified/ No Disclosure	Group 2: Unqualified/ Disclosure	Group 3: Adverse		
Likelihood of Lawsuit against Auditor	84.8 *	88.2 *	74.1 *	3.021	0.053
Strength of Case against Auditor	5.636 **	5.333 **	4.702 **	3.253	0.043
Auditor Lawsuit Recommended	6.090 ***	6.100 ***	5.000 ***	5.394	0.006

* Group 3 differs from Group 1 ($p=0.073$) and Group 2 ($p=0.023$)

** Group 3 differs from Group 1 ($p=0.015$) and Group 2 ($p=0.100$)

*** Group 3 differs from Group 1 ($p=0.006$) and Group 2 ($p=0.007$)

Table 6: Measurement of Top Management Litigation Exposure

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding Within Specified Range				
				< 50	50-69	70-89	90 - 99	100
				What is the likelihood (from 0 to 100%) that a lawsuit will be filed against the managers/executives?	1	83.1	23.518	6.1%
	2	92.3	13.547	0.0%	6.7%	10.0%	26.7%	56.7%
	3	84.1	24.881	8.1%	5.4%	18.9%	24.3%	43.2%
	Overall	86.2	21.766	5.0%	7.0%	19.0%	22.0%	47.0%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1)	Neither			(7)		
				Extremely Weak Case	Somewhat Weak	Slightly Weak	Strong or Weak	Slightly Strong	Somewhat Strong	Extremely Strong Case
Please indicate your opinions about the strength of a potential case against the managers/executives.	1	5.667	1.429	0.0%	3.0%	3.0%	21.2%	9.1%	24.2%	39.4%
	2	6.267	0.868	0.0%	0.0%	0.0%	6.7%	6.7%	40.0%	46.7%
	3	5.892	1.410	2.7%	2.7%	2.7%	0.0%	18.9%	32.4%	40.5%
	Overall	5.930	1.289	1.0%	2.0%	2.0%	9.0%	12.0%	32.0%	42.0%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1)	Neither			(7)		
				Strongly Disagree	Somewhat Disagree	Slightly Disagree	Agree or Disagree	Slightly Agree	Somewhat Agree	Strongly Agree
I would advise stockholders to file a lawsuit against the top managers/executives.	1	6.152	1.121	0.0%	0.0%	0.0%	15.2%	9.1%	21.2%	54.5%
	2	6.400	0.932	0.0%	0.0%	3.3%	0.0%	10.0%	26.7%	60.0%
	3	5.973	1.590	5.4%	0.0%	2.7%	5.4%	10.8%	21.6%	54.1%
	Overall	6.160	1.269	2.0%	0.0%	2.0%	7.0%	10.0%	23.0%	56.0%

*404 Reporting Condition groups are as follows: 1=Unqualified opinion with no disclosure, 2=Unqualified opinion with disclosure, 3=Adverse opinion

Table 7: Measurement of Audit Committee Litigation Exposure

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding Within Specified Range				
				< 50	50-69	70-89	90 - 99	100
What is the likelihood (from 0 to 100%) that a lawsuit will be filed against the audit committee?	1	70.0	30.927	21.2%	21.2%	12.1%	15.2%	30.3%
	2	87.2	15.794	0.0%	13.3%	16.7%	30.0%	40.0%
	3	81.3	23.538	5.4%	16.2%	21.6%	21.6%	35.1%
	Overall	79.4	25.072	9.0%	17.0%	17.0%	22.0%	35.0%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1) Extremely Weak Case	Somewhat Weak	Slightly Weak	Neither Strong or Weak	Slightly Strong	Somewhat Strong	(7) Extremely Strong Case
Please indicate your opinions about the strength of a potential case against the audit committee.	1	5.344	1.619	3.0%	6.1%	3.0%	30.3%	15.2%	24.2%	18.2%
	2	6.200	1.186	0.0%	3.3%	3.3%	3.3%	26.7%	40.0%	23.3%
	3	5.351	1.798	2.7%	2.7%	13.5%	8.1%	18.9%	37.8%	16.2%
	Overall	5.606	1.609	2.0%	4.0%	7.0%	14.0%	20.0%	34.0%	19.0%

Question Text	404 Report Condition*	Mean	SD	Percentage of Individuals Per Condition Responding to Corresponding Answers Below						
				(1) Strongly Disagree	Somewhat Disagree	Slightly Disagree	Neither Agree or Disagree	Slightly Agree	Somewhat Agree	(7) Strongly Agree
I would advise stockholders to file a lawsuit against the audit committee.	1	4.969	1.596	0.0%	6.3%	6.3%	21.9%	15.6%	12.5%	37.5%
	2	5.667	1.184	0.0%	3.3%	3.3%	0.0%	6.7%	36.7%	50.0%
	3	5.162	1.537	8.1%	2.7%	2.7%	8.1%	21.6%	24.3%	32.4%
	Overall	5.253	1.473	3.0%	4.0%	4.0%	10.1%	15.2%	24.2%	39.4%

*404 Reporting Condition groups are as follows: 1=Unqualified opinion with no disclosure, 2=Unqualified opinion with disclosure, 3=Adverse opinion

Table 8: Analysis of Top Management Litigation Exposure

Panel 1: MANOVA of Top Management Litigation Exposure

Variable	Wilks' Lambda	F-Statistic	P-Value (two-tailed)	Partial Eta Squared
404 Report	0.917	1.395	0.218	0.042

Dependent Variable = Management Litigation Exposure (all measures)

Panel 2: Separate ANOVA's of Top Management Litigation Exposure

Question	Mean (by 404 Report Condition)			P-Value	
	Unqualified/ No Disclosure	Unqualified/ Disclosure	Adverse	F-Score	(two-tailed)
Likelihood of Lawsuit against Top Management	83.090	92.300	84.108	1.710	0.186
Strength of Case against Top Management	5.666	6.266	5.892	1.754	0.178
Top Management Lawsuit Recommended	6.152	6.400	5.973	0.938	0.395

Table 9: Analysis of Audit Committee Litigation Exposure

Panel 1: MANOVA of Audit Committee Litigation Exposure

Variable	Wilks' Lambda	F-Statistic	P-Value (two-tailed)	Partial Eta Squared
404 Report	0.879	2.093	0.056	0.063

Dependent Variable = Audit Committee Litigation Exposure (all measures)

Panel 2: Separate ANOVA's of Audit Committee Litigation Exposure

Question	Mean (by 404 Report Condition)			F-Score (two-tailed)	P-Value
	Unqualified/No Disclosure	Unqualified/Disclosure	Adverse		
Likelihood of Lawsuit against Audit Committee	70.000 *	87.166 *	81.324 *	4.032	0.021
Strength of Case against Audit Committee	4.968	5.666	5.162	1.882	0.158
Audit Committee Lawsuit Recommended	5.343 **	6.200 **	5.351 **	3.057	0.052

* Group 1 differs from Group 2 ($p=0.007$) and Group 3 ($p=0.057$)

** Group 2 differs from Group 1 ($p=0.035$) and Group 3 ($p=0.031$)

Table 10: Evaluation of Internal Control Deficiencies

	<i>Impact is Inconsequential</i>	<i>Impact is More than Inconsequential</i>	<i>Impact is Material</i>
<i>Remote Chance of Misstatement</i>	Control Deficiency (Unqualified 404 opinion, No Disclosure Required)	Control Deficiency (Unqualified 404 opinion, No Disclosure Required)	Control Deficiency (Unqualified 404 opinion, No Disclosure Required)
<i>More than Remote Chance of Misstatement</i>	Control Deficiency (Unqualified 404 opinion, No Disclosure Required)	Significant Deficiency (Unqualified 404 opinion, No Disclosure Required under AS5/404, required under SAS 112)	Material Weakness (Adverse 404 opinion, Disclosure Required)

(adapted from Asare et al., 2007)

Table 11: Overview of Research Methodology Examining the Effect of Auditors’ Internal Control Disclosures and the Nature of Internal Control Deficiencies on Jurors’ Evaluation of Auditor Liability

	Disclosure of Significant Deficiencies, Independent Variable = Disclosure (Not Disclosed/Disclosed)	
Nature/Auditability of Deficiency Independent Variable = ‘MW Type’ (Less/More Auditable)	Significant Deficiencies Not Disclosed; Less Auditable Deficiency (Cell 1) N=25	Significant Deficiencies Disclosed; Less Auditable Deficiency (Cell 2) N=23
	Significant Deficiencies Not Disclosed; More Auditable Deficiency (Cell 3) N=20	Significant Deficiencies Disclosed; More Auditable Deficiency (Cell 4) N=25

H1: In a litigation setting, jurors will evaluate auditors more favorably when an audit failure is due to a more auditable internal control weakness than when an audit failure is due to a less auditable internal control weakness. [(Cells 1 and 2) compared to (Cells 3 and 4)]

H2: In a litigation setting, jurors will evaluate auditors who report an unqualified opinion on internal controls with voluntary disclosures of significant internal control deficiencies more favorably than auditors who report an unqualified opinion on internal controls without voluntary disclosures of significant internal control deficiencies. [(Cells 2 and 4) compared to (Cells 1 and 3)]

Table 12: Demographic Information

Panel A: General Demographic Characteristics

Condition	N	Called for Jury Duty		Served on Jury			Age					Gender	
		No	Yes	No	Civil Trial	Criminal Trial	Mean	Under 25	25-44	45-64	65+	Male	Female
Not Disclosed / Less Auditable	25	36.0%	64.0%	64.0%	12.0%	24.0%	49	12.0%	4.0%	72.0%	12.0%	54.2%	45.8%
Not Disclosed / More Auditable	20	30.0%	70.0%	75.0%	10.0%	15.0%	46	5.0%	30.0%	55.0%	10.0%	50.0%	50.0%
Disclosed / Less Auditable	23	30.4%	69.6%	78.3%	8.7%	13.0%	46	4.5%	31.8%	54.5%	9.1%	30.4%	69.6%
Disclosed / More Auditable	25	28.0%	72.0%	64.0%	12.0%	24.0%	48	8.3%	25.0%	62.5%	4.2%	44.0%	56.0%
Overall	93	31.2%	68.8%	70.3%	10.7%	19.0%	47	7.5%	22.7%	61.0%	8.8%	44.6%	55.4%
<i>*National Average</i>		<i>35.0%</i>	<i>65.0%</i>	<i>62.6%</i>	<i>37.4% (all types)</i>		<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>46.0%</i>	<i>53.0%</i>

*Represents responses to a recent poll concerning the average amount of individuals who have been called for jury duty or served on a jury (Harris Interactive, 2008).

Panel B: Political Party Affiliation

Condition	N	Political Party Affiliation			
		Republican	Democrat	Independent	Other
Not Disclosed / Less Auditable	25	52.0%	16.0%	28.0%	4.0%
Not Disclosed / More Auditable	20	40.0%	45.0%	15.0%	0.0%
Disclosed / Less Auditable	23	36.8%	31.6%	26.3%	5.3%
Disclosed / More Auditable	25	37.5%	25.0%	33.3%	4.2%
Overall	93	42.1%	28.4%	26.1%	3.4%

Table 13: Additional Demographic Characteristics

Panel A: Employment Status

Condition	N	Employment Status					
		Full-Time	Part-Time	Self-Employed	Retired	Homemaker	Unemployed
Not Disclosed / Less Auditable	25	64.0%	20.0%	12.0%	4.0%	4.0%	0.0%
Not Disclosed / More Auditable	20	50.0%	30.0%	5.0%	10.0%	5.0%	5.0%
Disclosed / Less Auditable	23	52.2%	17.4%	4.3%	13.0%	4.3%	8.7%
Disclosed / More Auditable	25	64.0%	12.0%	8.0%	4.0%	8.0%	4.0%
Overall	93	58.1%	19.4%	7.5%	7.5%	5.4%	4.3%

Panel B: Annual Household Income

Condition	N	Annual Income								
		<\$10 K	\$10-24 K	\$25-39 K	\$40-54 K	\$50-69 K	\$70-84 K	\$85-99 K	\$100-199 K	>\$200 K
Not Disclosed / Less Auditable	25	0.0%	4.0%	8.0%	4.0%	4.0%	4.0%	8.0%	40.0%	28.0%
Not Disclosed / More Auditable	20	0.0%	16.7%	11.1%	0.0%	11.1%	11.1%	0.0%	38.9%	11.1%
Disclosed / Less Auditable	23	9.1%	9.1%	13.6%	9.1%	0.0%	9.1%	27.3%	18.2%	4.5%
Disclosed / More Auditable	25	<u>0.0%</u>	<u>4.0%</u>	<u>12.0%</u>	<u>8.0%</u>	<u>8.0%</u>	<u>8.0%</u>	<u>20.0%</u>	<u>36.0%</u>	<u>4.0%</u>
Overall	93	2.2%	7.8%	11.1%	5.6%	5.6%	7.8%	14.4%	33.3%	12.2%

Table 14: Education of Participants

Condition	N	Highest Level of Education*					
		High School	Trade School	Some College	Undergrad. Degree	Some Post Grad.	Grad. Degree
Not Disclosed / Less Auditable	25	0.0%	4.0%	40.0%	12.0%	16.0%	28.0%
Not Disclosed / More Auditable	20	5.0%	0.0%	25.0%	25.0%	10.0%	35.0%
Disclosed / Less Auditable	23	4.3%	8.7%	21.7%	39.1%	17.4%	8.7%
Disclosed / More Auditable	25	4.0%	4.0%	36.0%	40.0%	12.0%	4.0%
Overall	93	3.2%	4.3%	31.2%	29.0%	14.0%	18.3%

*All participants finished high school

Table 15: Summary of Responses to All Measurements of Auditor Liability

Panel A: Summary of Responses to Liable/Not Liable Decision

Condition	Count (percentage)	Count (percentage)
	"Not Liable"	"Liable"
Not Disclosed / Less Auditable	12 (48.0%)	13 (52.0%)
Not Disclosed / More Auditable	13 (65.0%)	7 (35.0%)
Disclosed / Less Auditable	12 (52.2%)	11 (47.8%)
Disclosed / More Auditable	23 (92.0%)	2 (8.0%)
Overall: All Groups	60 (62.5%)	33 (35.5%)

Chi-square = 12.76

$p=0.005$

Panel B: Summary of Compensatory and Punitive Damages Assessed against the Auditor

Condition	Compensatory Damages*		Punitive Damages**	
	(In \$ Millions)		(In \$ Millions)	
	Mean	SD	Mean	SD
Not Disclosed/Less Auditable	44.400	48.225	40.400	67.483
Not Disclosed/More Auditable	16.000	32.509	3.525	11.814
Disclosed/Less Auditable	35.657	44.086	20.283	53.590
Disclosed/More Auditable	4.200	19.983	0.000	0.000
Overall Mean:	25.324	40.738	16.634	46.615

*Overall means were significantly different between all groups ($p=0.001$)

**Overall means were significantly different between all groups ($p=0.008$)

Panel C: Summary of Responses to Auditor Liability Perceptions

Dependent Variable (Higher rating = less favorable)		Condition	
		Not Disclosed	Disclosed
ABC CPA Firm is liable for negligent misrepresentation	Less Auditable	4.480	4.000
	More Auditable	3.000	2.160 *
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed	Less Auditable	3.560	2.913
	More Auditable	2.950	1.520 *
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose	Less Auditable	3.880	3.391
	More Auditable	3.500	1.680 *
ABC CPA Firm could have prevented the stockholder losses	Less Auditable	4.600	4.174
	More Auditable	4.250	2.960 *
ABC CPA Firm is responsible for stockholder losses	Less Auditable	3.720	3.435
	More Auditable	3.100	2.520

Numbers in table represent mean responses measured on a scale from 1-7. Answers were re-coded so that a higher number indicate less favorable view of the auditor

*Results of multiple comparisons of the means indicate that the Disclosed/More Auditable group responses are significantly different compared to all other groups ($p < 0.05$)

Panel D: Factor Analysis Results of Auditor Liability Perceptions

Auditor Liability Measure	Factor Loading
ABC CPA Firm is liable for negligent misrepresentation	0.912
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed	0.851
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose	0.885
ABC CPA Firm could have prevented the stockholder losses	0.828
ABC CPA Firm is responsible for stockholder losses	0.872
Total variance explained	75.7%

Table 16: Tests of the Impact of Material Weakness Type (H1) and Disclosure (H2) on Auditor Liability

Panel A: Logistic Regression Analysis of Liable/Not Liable Judgments

Predictor	β	Wald χ^2	p	Odds ratio	Overall Model Statistics		Model Predictions*	
					χ^2	p	% Correct "Not Liable"	% Correct "Liable"
Constant	0.353	0.922	0.169	1.424	11.966	0.003	80.0%	39.4%
MW Type	-1.370	8.218	0.002	0.254				
Disclosure	-0.738	2.526	0.056	0.478	Nagelkerke R ²	0.166	Overall	65.6%

Dependent Variable = Liable/Not Liable Judgment (0=Not Liable, 1=Liable)

Independent Variables= MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

*Communicates how successful the model is at predicting the DV

Panel B: MANOVA of Compensatory and Punitive Damages

Variable	Wilks' Lambda	F-Statistic	P-Value	Partial Eta Squared
MW Type	0.849	7.835	0.001	0.151
Disclosure	0.976	1.065	0.175	0.024
Disclosure xMW Type	0.984	0.726	0.244	0.016

Dependent Variable = Damages (measured by Compensatory and Punitive Damages)

Independent Variables= MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

Panel C: ANOVA of Compensatory Damages

Variable*	F-Statistic	P-Value (two-tailed)
MW Type	14.333	0.000
Disclosure	1.688	0.197
Disclosure x MW Type	0.037	0.847

Model Statistics:

F = 5.656

$p = 0.001$

Dependent Variable = Damages (measured by Compensatory Damages)

Independent Variable = MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

Mean Compensatory Damages (In Millions)		
	Not Disclosed	Disclosed
Less Auditable	44.400	35.657
More Auditable	16.000	4.200

Panel D: ANOVA of Punitive Damages

Variable*	F-Statistic	P-Value (two-tailed)
MW Type	9.571	0.003
Disclosure	1.637	0.204
Disclosure x MW Type	0.807	0.372

Model Statistics:

F = 4.198

$p = 0.008$

Dependent Variable = Damages (measured by Punitive Damages)

Independent Variable = MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

Mean Punitive Damages (In Millions)		
	Not Disclosed	Disclosed
Less Auditable	40.400	20.283
More Auditable	3.525	.000

Panel E: ANOVA of Auditor Liability Perception Factor Scores

Variable	F-Statistic	P-Value
MW Type	8.021	0.006
Disclosure	5.207	0.025
Disclosure x MW Type	1.011	0.347

Dependent Variable = Auditor Liability (Factor Scores)

Independent Variables= MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

Standardized Mean Factor Scores by Condition*

	Not Disclosed	Disclosed
Less Auditable	.407	.158
More Auditable	.050	-.593

*lower scores mean more favorable/lower liability evaluations

Table 17: Logistic Regression Analysis of Liable/Not Liable Judgments for the Interaction between Material Weakness Type and Disclosure

Predictor	β	Wald χ^2	<i>p</i>	Odds ratio	Overall Model Statistics		Model Predictions*	
Constant	0.080	0.040	0.421	1.083	χ^2	14.678	% Correct "Not Liable"	80.0%
MW Type x Disclosure	-1.656	2.499	0.057	0.191	<i>p</i>	0.002	% Correct "Liable"	39.4%
MW Type	-0.699	1.286	0.128	0.497	Nagelkerke R^2	0.201	Overall	65.6%
Disclosure	-0.167	0.083	0.386	0.846				

Dependent Variable = Liable/Not Liable Judgment (0=Not Liable, 1=Liable)

Independent Variables= MW Type (0=Less Auditable, 1=More Auditable) and Disclosure (0=Not Disclosed, 1=Disclosed)

*Communicates how successful the model is at predicting the DV

Table 18: Summary of Results

<i>Analysis</i>	<i>Auditor Liability Measure</i>			
	Liable/Not Liable	Compensatory damages	Punitive damages	Auditor Liability Factor
H1: MW Type	Supported*	Supported	Supported	Supported
H2: Disclosure	Supported*	Not supported	Not supported	Supported
Additional Analysis: Interaction Between MW Type and Disclosure	Supported	Not supported	Not supported	Not supported

* The main effects for MW Type and Disclosure were significant in the main effects only model, but not significant when the interaction term was added.

Table 19: Overview of Research Methodology Examining the Effect of Audit Committee Member Independence and Audit Committee Member Expertise on Jurors' Evaluation of Auditor Liability

	Audit Committee Member Expertise (Low/High)	
Audit Committee Member Independence (Low/High)	Low Expertise / Low Independence (Cell 1) N=29	High Expertise / Low Independence (Cell 2) N=29
	Low Expertise / High Independence (Cell 3) N=28	High Expertise / High Independence (Cell 4) N=30

Table 20: Sample Demographics

Panel A: Comparisons to National Average

	Called for Jury Duty	Served on Jury			Age					Gender	
		No Service	Civil Trial	Criminal Trial	Mean	Under 25	25-44	45-64	65+	Male	Female
Count	85	92	11	13		8	19	80	9	51	65
Percentage	73.3%	79.3%	9.5%	11.2%	49	6.9%	16.5%	68.7%	7.8%	43.9%	56.1%
<i>*National Average</i>	<i>65.0%</i>	<i>62.6%</i>	<i>37.4% (all types)</i>		<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>n/a</i>	<i>56.0%</i>	<i>53.0%</i>

*Represents responses to a recent poll concerning the average amount of individuals who have been called for jury duty or served on a jury (Harris Interactive, 2008).

Panel B: Political Party Affiliation

	Political Party Affiliation			
	Republican	Democrat	Independent	Other
Count	59	38	17	2
Percentage	50.5%	33.0%	14.7%	1.8%

Panel C: Employment Status

	Employment Status					
	Full-Time	Part-Time	Self-Employed	Retired	Homemaker	Unemployed
Count	60	13	9	17	15	2
Percentage	51.7%	11.2%	7.8%	14.7%	12.9%	1.7%

Panel D: Household Income

		Annual Household Income								
		<\$10 K	\$10-24 K	\$25-39 K	\$40-54 K	\$50-69 K	\$70-84 K	\$85-99 K	\$100-199 K	>\$199 K
Count		5	0	15	9	16	14	9	40	9
Percentage		4.6%	0.0%	12.9%	7.4%	13.9%	12.0%	7.4%	34.2%	7.4%

Panel E: Education

		Highest Level of Education					
		High School	Trade School	Some College	Undergrad. Degree	Some Post Grad.	Grad. Degree
Count		7	4	32	45	14	13
Percentage		6.1%	3.5%	27.8%	39.1%	12.2%	11.3%

Table 21: Audit Committee Expertise Measurement, Scale Validation, and Descriptive Statistics

Panel A: Mean Perceptions of Audit Committee Expertise

Question (Higher Numbers = Higher Expertise)	Expertise Manipulation	
	Low	High
The audit committee had the relevant expertise for their job*	2.509	5.746
The audit committee had expertise in finance*	2.018	5.763
The audit committee had expertise in accounting*	1.965	5.695
The audit committee was able to comprehend the issues that arose during the audit*	3.930	6.051
The audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit*	2.965	5.847
The audit committee's experience influenced the quality of the decisions made during the audit*	4.807	5.847

Numbers in table represent mean responses measured on a scale from 1="strongly disagree" to 7="strongly agree", with higher numbers representing higher levels of expertise.

*Notes a significant difference between groups ($p < 0.001$)

Panel B: Factor Analysis of Audit Committee Expertise Measures

Question	Factor Loading
The audit committee had the relevant expertise for their job.	0.942
The audit committee had expertise in finance.	0.947
The audit committee had expertise in accounting.	0.945
The audit committee was able to comprehend the issues that arose during the audit.	0.821
The audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit.	0.966
The audit committee's experience influenced the quality of the decisions made during the audit.	0.965
Total variance explained	86.9%

Table 22: Audit Committee Independence Measurement, Scale Validation, and Descriptive Statistics

Panel A: Mean Perceptions of Audit Committee Independence

Question (Higher Numbers=Higher Independence)	Independence Manipulation	
	Low	High
The audit committee members were objective during the 2007 audit of Clovitech, Inc. (reverse coded)*	2.431	4.524
The audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.*	2.155	4.129
Management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management*	2.121	2.670
The audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.*	1.914	3.448
The audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management*	2.121	4.045

All numbers in table represent mean responses measured on a scale from 1="strongly agree" to 7="strongly disagree"

*Notes a significant difference between groups (p<0.001)

Panel B: Factor Analysis of Audit Committee Independence Measures

Question	Factor Loading
The audit committee members were objective during the 2007 audit of Clovitech, Inc.	0.839
The audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.	0.906
<i>Management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management (dropped)</i>	<i>0.350</i>
The audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.	0.825
The audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management.	0.894
Total variance explained	75.1%

Table 23: Auditor Independence Measurement, Scale Validation, and Descriptive Statistics:

Panel A: Mean Perceptions of Auditor Independence

Question (Higher Numbers=Higher Independence)	Means By Condition		
	Low Expertise	High Expertise	
ABC CPA Firm was objective during their 2007 audit of Clovitech, Inc. (reverse coded)*	Low Independence	4.621	4.379
	High Independence	5.179	5.600
ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.*	Low Independence	3.448	3.034
	High Independence	4.643	4.367
Management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management	Low Independence	2.448	2.103
	High Independence	2.607	2.667
ABC CPA Firm's decisions during the audit were influenced by the managers of Clovitech, Inc.*	Low Independence	2.448	2.138
	High Independence	3.429	3.400
ABC CPA Firm was protecting its own interest by not warning stockholders of the client's deficiencies in the internal controls established by top management*	Low Independence	3.552	2.724
	High Independence	4.143	4.033

Numbers in table represent mean responses measured on a scale from 1="strongly agree" to 7="strongly disagree".

*Means were significantly different between groups ($p < 0.05$)

Panel B: Factor Analysis of Auditor Independence Measures

Question	Factor Loading
ABC CPA Firm was objective during their 2007 audit of Clovitech, Inc.	0.783
ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.	0.855
<i>Management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management (dropped)</i>	0.550
ABC CPA Firm's decisions during the audit were influenced by the managers of Clovitech, Inc.	0.733
ABC CPA Firm was protecting its own interest by not warning stockholders of the client's deficiencies in the internal controls established by top management	0.907
Total variance explained	67.6%

Table 24: Auditor Liability Measurement, Scale Validation, and Descriptive Statistics

Panel A: Mean Perceptions of Auditor Liability

Auditor Liability Measure (Higher Numbers = More Liable/Less Favorable)	Means by Condition		
	Low Expertise	High Expertise	
ABC CPA Firm is liable for negligent misrepresentation (reverse coded)*	Low Independence	4.379	5.138
	High Independence	4.536	3.433
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed	Low Independence	3.552	3.517
	High Independence	3.250	2.533
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose*	Low Independence	3.724	4.414
	High Independence	3.571	2.467
ABC CPA Firm could have prevented the stockholder losses (reverse coded)*	Low Independence	4.793	4.828
	High Independence	4.393	3.633
ABC CPA Firm is responsible for stockholder losses (reverse coded)	Low Independence	3.828	4.276
	High Independence	3.679	3.167

All items were measured on a scale from 1="strongly agree" to 7="strongly disagree". Answers were reverse coded so that a higher number indicate less favorable view of the auditor

*Means were significantly different between conditions ($p < 0.05$)

Panel B: Factor Analysis of Auditor Liability Perception Measures

Auditor Liability Measure	Factor Loading
ABC CPA Firm is liable for negligent misrepresentation	0.905
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed	0.759
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose	0.774
ABC CPA Firm could have prevented the stockholder losses	0.773
ABC CPA Firm is responsible for stockholder losses	0.897
Total variance explained	67.9%

Panel C: Percentage Finding Auditor Liable and Not Liable per Group

Condition*	Count (percentage) "Liable"	Count (percentage) " Not Liable"
Low Independence/Low Expertise	16 (52.2%)	13 (44.8%)
Low Independence/High Expertise	19 (65.5%)	10 (34.5%)
High Independence/High Expertise	11 (36.7%)	19 (63.3%)
High Independence/Low Expertise	13 (46.4%)	15 (53.6%)
Overall: All Groups	59 (50.9%)	57 (49.1%)

*Means for Low Independence groups are significantly different than the means for High Independence Groups ($p=0.041$)

Panel D: Mean Damages Awarded per Group

Auditor Liability Measure	Means by Condition	
	Low Expertise	High Expertise
Compensatory Damages (in millions)	Low Independence	3.435
	High Independence	3.745
Punitive Damages (in millions)*	Low Independence	2.643
	High Independence	2.420
	Low Independence	2.628
	High Independence	5.610
	Low Independence	2.329
	High Independence	1.503

*Means were significantly different between conditions ($p=0.02$)

Table 25: PLS Results

Panel A: Tests of Convergent Validity

Variable Measures	Factor Loading	Construct Composite Reliability	Average Variance Extracted
<i>Audit Committee Expertise</i>		0.883	0.746
The audit committee had the relevant expertise for their job.	0.810		
The audit committee had expertise in finance.	0.802		
The audit committee had expertise in accounting.	0.799		
The audit committee was able to comprehend the issues that arose during the audit.	0.968		
The audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit.	0.891		
The audit committee's experience influenced the quality of the decisions made during the audit.	0.899		
<i>Audit Committee Independence</i>		0.921	0.745
The audit committee members were objective during the 2007 audit of Clovitech, Inc.	0.833		
The audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.	0.903		
<i>Management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management (Dropped).</i>	0.606		
The audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.	0.819		
The audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management.	0.894		
<i>Auditor Independence</i>		0.890	0.671
ABC CPA Firm was objective during their 2007 audit of Clovitech, Inc.	0.763		
ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.	0.852		
<i>Management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management (Dropped).</i>	0.524		
ABC CPA Firm's decisions during the audit were influenced by the managers of Clovitech, Inc.	0.751		
ABC CPA Firm was protecting its own interest by not warning stockholders of the client's deficiencies in the internal controls established by top management.	0.901		

Variable Measures	Factor Loading	Construct Composite Reliability	Average Variance Extracted
<i>Auditor Liability</i>		0.913	0.679
ABC CPA Firm is liable for negligent misrepresentation.	0.910		
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed.	0.753		
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose.	0.736		
ABC CPA Firm could have prevented the stockholder losses.	0.795		
ABC CPA Firm is responsible for stockholder losses.	0.909		

Panel B: Squared Inner-Construct Correlations

	Auditor Independence	Audit Committee Expertise	Audit Committee Independence	Audit Committee Independence * Audit Committee Expertise	Auditor Liability
Auditor Independence	1.000				
Audit Committee Expertise	0.010	1.000			
Audit Committee Independence	0.405	0.022	1.000		
Audit Committee Independence * Audit Committee Expertise	0.286	0.125	0.678	1.000	
Auditor Liability	0.547	0.010	0.197	0.228	1.000

Panel C: Inner-Construct Correlations

	Auditor Independence	Audit Committee Expertise	Audit Committee Independence	Audit Committee Independence * Audit Committee Expertise	Auditor Liability
Auditor Independence	1.000				
Audit Committee Expertise	-0.099	1.000			
Audit Committee Independence	0.637	-0.147	1.000		
Audit Committee Independence * Audit Committee Expertise	0.535	0.353	0.823	1.000	
Auditor Liability	-0.740	-0.100	-0.444	-0.478	1.000

Panel D: Item Loadings and Cross-Loadings

	Audit Committee Expertise	Audit Committee Independence	Auditor Independence	Auditor Liability
The audit committee had the relevant expertise for their job.	0.810	0.032	-0.009	-0.152
The audit committee had expertise in finance.	0.802	0.029	-0.027	-0.053
The audit committee had expertise in accounting.	0.799	0.047	-0.004	-0.062
The audit committee was able to comprehend the issues that arose during the audit.	0.968	-0.222	-0.132	-0.084
The audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit.	0.891	-0.001	0.016	0.148
The audit committee's experience influenced the quality of the decisions made during the audit.	0.899	-0.006	-0.018	-0.143
The audit committee members were objective during the 2007 audit of Clovitech, Inc.	-0.022	0.833	0.537	-0.418
The audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.	-0.187	0.903	0.559	-0.395
<i>Management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management (dropped).</i>	-0.168	0.606	0.361	-0.269
The audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.	-0.114	0.819	0.482	-0.266
The audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management.	-0.176	0.894	0.609	-0.437
ABC CPA Firm was objective during their 2007 audit of Clovitech, Inc.	0.123	0.359	0.763	-0.587
ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.	-0.068	0.487	0.852	-0.682
<i>Management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management (dropped).</i>	-0.139	0.362	0.524	-0.316
ABC CPA Firm's decisions during the audit were influenced by the managers of Clovitech, Inc.	-0.154	0.644	0.751	-0.469
ABC CPA Firm was protecting its own interest by not warning stockholders of the client's deficiencies in the internal controls established by top management.	-0.185	0.575	0.901	-0.676

ABC CPA Firm is liable for negligent misrepresentation.	-0.088	-0.380	-0.690	0.910
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose.	-0.070	-0.411	-0.509	0.753
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed.	-0.200	-0.350	-0.499	0.736
ABC CPA Firm could have prevented the stockholder losses.	-0.044	-0.383	-0.644	0.795
ABC CPA Firm is responsible for stockholder losses.	-0.038	-0.321	-0.669	0.909

Table 26: Results of Additional Analysis of H1-H3

Panel A: ANOVA of Auditor Independence

Variable	F-Statistic	P-Value (two-tailed)
Audit Committee Expertise (H1)	0.592	0.443
Audit Committee Independence (H2)	16.315	0.001
Audit Committee Expertise x Audit Committee Independence (H3)	1.247	0.267

Model Statistics:

F= 6.275

p = 0.001

R-squared= 0.156

Dependent Variable = Auditor Independence Factor Score

Independent Variables = Experimental Condition for Audit Committee Independence (0=Low, 1=High) and Audit Committee Expertise (0=Low, 1=High)

Panel B: Mean Factor Scores for Auditor Independence Organized by Experimental Condition

<u>Audit Committee Independence</u>	<u>Audit Committee Expertise</u>	
	Low Expertise	High Expertise
Low Independence	-.196	-.539
High Independence	.334	.397

Lower scores mean lower independence evaluations.

Table 27: Results of Additional Analyses of H4

Panel A: Logistic Regression of Liable/Not Liable Judgments

<u>Predictor</u>	β	Wald χ^2	p	Odds ratio	<u>Overall Model Statistics</u>		<u>Model Predictions*</u>	
Constant	0.056	0.053	0.817	1.058	χ^2	43.141	% Correct "Not Liable"	77.4%
Auditor Independence	-1.651	26.683	0.001	0.192	p	0.001	% Correct "Liable"	75.5%
					Nagelkerke	0.446	Overall	76.4%

Dependent Variable = Liable/Not Liable Judgment (0=Not Liable, 1=Liable)

Independent Variables = Auditor Independence Factor Scores

*Communicates how successful the model is at predicting the DV

Panel B: Regression of Compensatory Damages

<u>Independent Variables</u>	β	p
Auditor Independence	-0.280	0.043

Overall model Statistics

F = 4.325

$p = 0.043$

R-Squared = 0.078

Auditor Liability (Compensatory Damages) = $\beta_0 + \beta_1$ Auditor Independence (Factor Scores)

Panel C: Regression of Punitive Damages

<u>Independent Variables</u>	<u>β</u>	<u>p</u>
Auditor Independence	-0.446	0.001

Overall model Statistics

F = 12.666

$p = 0.001$

R-Squared = 0.183

Auditor Liability (Punitive Damages) = $\beta_0 + \beta_1$ Auditor Independence (Factor Scores)

APPENDIX B: STUDY 1 CASES AND QUESTIONNAIRE

Overview of Study

The following section provides a summary of the events leading up to the bankruptcy of a public company. In this scenario, assume that stockholders lost significant amounts of money when the company declared bankruptcy, and are exploring the option of filing a lawsuit against those responsible for their losses. After you review the scenario, you will be asked for your opinions about the situation to gain your perspective on the options available for stockholders to recover their losses. Specifically, you will be asked to provide your opinions about the likelihood that the executives/management, independent auditor, and/or audit committee of the public company would be sued in this particular situation.

****NOTE: The task does not ask if YOU would take on the case personally, but asks you to provide your perceptions about the potential case from a legal standpoint, and the likelihood that specific parties would be sued by stockholders to recover their losses****

Please click on the following link to view details on the potential case. PDF file will open in a new window for you to either print or view on your computer screen. Once you have finished reviewing the materials, please return to this screen and click "Next" [View Case Materials](#)

Case Materials for Unqualified/No Disclosure Condition:

Background on Clovitech, Inc.

Clovitech, Inc. is a mid-sized public company that manufactures computer accessories in the U.S. In 2007, the company reported sales revenues of \$400 million, and reported an overall profit of \$200 million for the year. The independent auditor for Clovitech, Inc. reported a "clean" opinion on the financial statements and internal controls over financial reporting for 2007. Clovitech, Inc. recently announced a restatement of their 2007 financial statements, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million. They disclosed that a material weakness in internal controls in the company was the leading cause of the significant inaccuracies in the 2007 financial statements. This weakness in internal controls allowed employees to falsely inflate revenue figures and conceal significant declines in demand for products. Less than two weeks after this restatement announcement, Clovitech, Inc. declared bankruptcy.

The following section details a timeline of the events leading up to the bankruptcy of Clovitech, Inc. The stockholders of Clovitech, Inc. are alleging that they relied on misleading disclosures made concerning the 2007 financial statements when they purchased stock in the period between the release of the 2007 financial statements and the restatement announcement in 2009. This group of shareholders is seeking to recover their losses from the managers, the audit committee, and/or the independent auditors. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14. Following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million. Please examine the events leading up to this bankruptcy to decide which parties should

be sued to recover stockholder losses. Similar cases in the past have resulted in class action stockholder lawsuits against one or more parties, such as the company executives, the independent auditor, and the audit committee, alleging a range of offenses such as negligence, negligent misrepresentation, and fraud.

Events Surrounding Clovitech, Inc. Bankruptcy

January to March, 2008:

The independent auditor of Clovitech, Inc., a large international accounting firm that has performed independent audits for Clovitech, Inc. for 3 years, performs the audit of the 2007 financial statements and internal controls.

This audit is conducted under the requirements of the Sarbanes-Oxley Act of 2002, which requires independent auditors to conduct an evaluation of internal controls and release a report that communicates their findings. The Act also holds managers of public companies responsible for establishing and maintaining effective internal controls over financial reporting, and requires that an audit committee, consisting of members of the Board of Directors, oversee the audit process and resolve any issues that arise during the audit.

The independent auditor *identifies a significant deficiency in internal controls over inventory* indicating that the internal controls established by the top-level managers within the company may not be sufficient to prevent or detect material misstatements in the financial statements. Auditors are concerned that company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level.

The auditor *discloses their identification of a significant deficiency to the Audit Committee*. The deficiency is discussed in a meeting between the auditor, audit committee, and management to assess the likelihood that a material misstatement in the financial statements would not be prevented or detected because of the deficiency in internal controls. Clovitech's managers argue that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures, and that there is not a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of this deficiency. ***Management does NOT intend to disclose any details about the significant deficiency within their report on internal controls, and intend to communicate that they have maintained effective internal controls over financial reporting.***

The Audit Committee of Clovitech, Inc. supports management's decision and communicates their opinion to the auditor.

The independent auditor agrees with management and the audit committee that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures. ***The auditor decides NOT to modify their opinion on the 2007 financial statements, and to report that the 2007 financial statements are fairly stated.***

The independent auditor also agrees with management and the audit committee that there is not a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of this deficiency. ***The auditor decides NOT to disclose any details about the significant deficiency within their report on internal controls, and decides to communicate that Clovitech, Inc. has maintained effective internal controls over financial reporting.***

March 13, 2008:

Clovitech, Inc. reports 2007 annual sales revenues of \$400 million and an overall profit of \$200 million for the year.

Management's report on internal controls over financial reporting states that Clovitech, Inc. ***maintained effective internal control over financial reporting in 2007.*** This report ***contains no disclosure of any significant deficiencies*** in internal controls over inventory.

The auditor reports a ***“clean” opinion on internal controls***, stating that Clovitech, Inc. ***maintained effective internal control over financial reporting in 2007.*** This report contains ***no disclosure of any significant deficiencies*** in internal controls over inventory.

The independent auditor for Clovitech, Inc., reports a ***“clean” opinion on the financial statements*** for 2007, stating that ***the financial statements are fairly stated.***

March 13, 2008 to February 11, 2009:

After the release of the 2007 Annual Report, and prior to the restatement announcement, stockholders purchase a total of \$100 million in stock in Clovitech, Inc.

February 11, 2009:

Clovitech, Inc. ***announces a restatement of their 2007 financial statements***, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million. Clovitech, Inc. discloses that the misstatement in their previous 2007 financial statements occurred primarily due to a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Specifically, company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level. ***This particular internal control issue was identified as a significant deficiency during the audit of the 2007 financial statements and internal controls, but was NOT disclosed publicly.***

Individual sales representatives in multiple regional offices have admitted to inflating revenues to meet projections and concealing significant declines in demand for their products for the past 18 months. The activity had been occurring since the beginning of 2007. ***Because of the material weakness in internal controls over inventory, employees were able to falsely inflate sales revenues without being detected, resulting in a significant overstatement of sales revenues and profits in the financial statements of Clovitech, Inc. for 2007.***

Clovitech, Inc. *stock drops 50% in value* from \$28 to \$14 per share.

February 20, 2009:

Clovitech, Inc. files for Chapter 7 bankruptcy protection.

Clovitech, Inc. *stock is considered worthless*. The stockholders who purchased stock since the release of the 2007 financial statements are seeking advice about whether they have a case against the managers, independent auditor, and/or audit committee of Clovitech, Inc. to recover their estimated losses of \$100 million. *They believe that since they relied on misleading information in the 2007 financial statements and accompanying reports when purchasing the stock, they should be able to recover their losses.*

**You have now concluded the case portion of this task.
Please return to the survey and click “Next” to continue to the next screen.**

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Clovitech, Inc.:

We have audited Clovitech, Inc. and subsidiaries’ (the “Company’s”) internal control over financial reporting as of December 31, 2007 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on that risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting

includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's consolidated annual or interim financial statements will not be prevented or detected on a timely basis.

We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

In our opinion the Company has maintained effective internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control— Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended December 31, 2007, of the Company and our report dated March 19, 2008 expressed an unqualified opinion on those financial statements.

Managing Partner
ABC CPA Firm

MANAGEMENT’S REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of Clovitech, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a – 15(f) and 15d – 15(f) under the Securities Exchange Act of 1934. Clovitech, Inc.’s internal control system is designed to provide reasonable assurance to Clovitech’s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects Clovitech, Inc.’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of Clovitech, Inc.’s financial statements that is more than inconsequential will not be prevented or detected by the Clovitech Inc.’s internal control. An internal control material weakness is a significant deficiency, or combination of them, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The management of Clovitech, Inc. assessed the effectiveness of the company’s internal control over financial reporting as of December 31, 2007, and this assessment identified no material weaknesses in internal controls over financial reporting

The management of Clovitech Inc.’s assessed the effectiveness of Clovitech, Inc.’s internal control over financial reporting as of December 31, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on our assessment and those criteria, management believes that Clovitech, Inc. maintained effective internal control over financial reporting as of December 31, 2007.

Clovitech, Inc.’s independent registered public accounting firm has issued an audit report on its assessment of Clovitech, Inc.’s internal control over financial reporting.

Signed:

CEO of Clovitech, Inc.

CFO of Clovitech, Inc.

Case materials for Unqualified/Disclosure Condition:

Background on Clovitech, Inc.

Clovitech, Inc. is a mid-sized public company that manufactures computer accessories in the U.S. In 2007, the company reported sales revenues of \$400 million, and reported an overall profit of \$200 million for the year. The independent auditor for Clovitech, Inc. reported a “clean” opinion on the financial statements and internal controls over financial reporting for 2007.

Clovitech, Inc. recently announced a restatement of their 2007 financial statements, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million. They disclosed that a material weakness in internal controls in the company was the leading cause of the significant inaccuracies in the 2007 financial statements. This weakness in internal controls allowed employees to falsely inflate revenue figures and conceal significant declines in demand for products. Less than two weeks after this restatement announcement, Clovitech, Inc. declared bankruptcy.

The following section details a timeline of the events leading up to the bankruptcy of Clovitech, Inc. The stockholders of Clovitech, Inc. are alleging that they relied on misleading disclosures made concerning the 2007 financial statements when they purchased stock in the period between the release of the 2007 financial statements and the restatement announcement in 2009. This group of shareholders is seeking to recover their losses from the managers, the audit committee, and/or the independent auditors. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14. Following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million. Please examine the events leading up to this bankruptcy to decide which parties should be sued to recover stockholder losses. Similar cases in the past have resulted in class action stockholder lawsuits against one or more parties, such as the company executives, the independent auditor, and the audit committee, alleging a range of offenses such as negligence, negligent misrepresentation, and fraud.

Events Surrounding Clovitech, Inc. Bankruptcy

January to March, 2008:

The independent auditor of Clovitech, Inc., a large international accounting firm that has performed independent audits for Clovitech, Inc. for 3 years, performs the audit of the 2007 financial statements and internal controls.

This audit is conducted under the requirements of the Sarbanes-Oxley Act of 2002, which requires independent auditors to conduct an evaluation of internal controls and release a report that communicates their findings. The Act also holds managers of public companies responsible for establishing and maintaining effective internal controls over financial reporting, and requires that an audit committee, consisting of members of the Board of Directors, oversee the audit process and resolve any issues that arise during the audit.

The independent auditor *identifies a significant deficiency in internal controls over inventory* indicating that the internal controls established by the top-level managers within the company may not be sufficient to prevent or detect material misstatements in the financial statements. Auditors are concerned that company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level.

The auditor *discloses their identification of a significant deficiency to the Audit Committee*. The deficiency is discussed in a meeting between the auditor, audit committee, and management to assess the likelihood that a material misstatement in the financial statements would not be prevented or detected because of the deficiency in internal controls. Clovitech's managers argue that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures, and that there is not a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of this deficiency. *Management decides to disclose information about the significant deficiency within their report on internal controls, but intend to communicate that they have maintained effective internal controls over financial reporting.*

The Audit Committee of Clovitech, Inc. supports management's decision and communicates their opinion to the auditor.

The independent auditor agrees with management and the audit committee that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures. *The auditor decides NOT to modify their opinion on the 2007 financial statements, and to report that the 2007 financial statements are fairly stated.*

The independent auditor also agrees with management and the audit committee that there is not a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of this deficiency. *The auditor decides to disclose details about the significant deficiency within their report on internal controls, but decides to communicate that Clovitech, Inc. has maintained effective internal controls over financial reporting.*

March 13, 2008:

Clovitech, Inc. reports 2007 annual sales revenues of \$400 million and an overall profit of \$200 million for the year.

Management's report on internal controls over financial reporting states that Clovitech, Inc. *maintained effective internal control over financial reporting in 2007*. This report also *contains a disclosure of a significant deficiency* in internal controls over inventory.

The auditor reports a "*clean*" *opinion on internal controls*, stating that Clovitech, Inc. *maintained effective internal control over financial reporting in 2007*. This report also *contains a disclosure of a significant deficiency in internal controls over inventory*.

The independent auditor for Clovitech, Inc., reports a “*clean*” *opinion on the financial statements* for 2007, stating that *the financial statements are fairly stated*.

March 13, 2008 to February 11, 2009:

After the release of the 2007 Annual Report, and prior to the restatement announcement, stockholders purchase a total of \$100 million in stock in Clovitech, Inc.

February 11, 2009:

Clovitech, Inc. *announces a restatement of their 2007 financial statements*, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million.

Clovitech, Inc. discloses that the misstatement in their previous 2007 financial statements occurred primarily due to a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Specifically, company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level. *This particular internal control issue was identified as a significant deficiency during the audit of the 2007 financial statements and internal controls, and was disclosed publicly within management’s report on internal controls and the auditor’s report on internal controls.*

Individual sales representatives in multiple regional offices have admitted to inflating revenues to meet projections and concealing significant declines in demand for their products for the past 18 months. The activity had been occurring since the beginning of 2007. *Because of the material weakness in internal controls over inventory, employees were able to falsely inflate sales revenues without being detected, resulting in a significant overstatement of sales revenues and profits in the financial statements of Clovitech, Inc. for 2007.*

Clovitech, Inc. *stock drops 50% in value* from \$28 to \$14 per share.

February 20, 2009:

Clovitech, Inc. files for Chapter 7 bankruptcy protection.

Clovitech, Inc. *stock is considered worthless*. The stockholders who purchased stock since the release of the 2007 financial statements are seeking advice about whether they have a case against the managers, independent auditor, and/or audit committee of Clovitech, Inc. to recover their estimated losses of \$100 million. *They believe that since they relied on misleading information in the 2007 financial statements and accompanying reports when purchasing the stock, they should be able to recover their losses.*

You have now concluded the case portion of this task.

Please return to the survey and click “Next” to continue to the next screen.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Clovitech, Inc.:

We have audited Clovitech, Inc. and subsidiaries' (the "Company's") internal control over financial reporting as of December 31, 2007 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on that risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's consolidated annual or interim financial statements will not be prevented or detected on a timely basis.

We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above. However, we identified the following deficiency in internal control that we consider to be a significant deficiency:

The Company has a significant deficiency in the internal controls established by top management. Specifically, management are deficient in the following: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, and iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel

As a result of this deficiency, there is a more than remote likelihood that internal controls over financial reporting may not have prevented or detected errors from occurring that could have been more than inconsequential, either individually or in the aggregate.

This significant deficiency was considered in determining the nature, timing, and extent of audit tests applied in our audit of the financial statements as of and for the year ended December 31, 2007, of the Company and this report does not affect our report on such financial statements.

In our opinion, in spite of the effect of the significant deficiency identified above on the achievement of the objectives of the control criteria, the Company has maintained effective internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control— Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended December 31, 2007, of the Company and our report dated March 19, 2008 expressed an unqualified opinion on those financial statements.

Managing Partner
ABC CPA Firm

MANAGEMENT’S REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of Clovitech, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a – 15(f) and 15d – 15(f) under the Securities Exchange Act of 1934. Clovitech, Inc.’s internal control system is designed to provide reasonable assurance to Clovitech’s management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects Clovitech, Inc.’s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of Clovitech, Inc.’s financial statements that is more than inconsequential will not be prevented or detected by the Clovitech Inc.’s internal control. An internal control material weakness is a significant deficiency, or combination of them, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. This assessment identified no material weaknesses in internal controls over financial reporting. However, we considered the deficiency described in the paragraph below to be a significant deficiency in internal control over financial reporting.

The management of Clovitech, Inc. assessed the effectiveness of the company’s internal control over financial reporting as of December 31, 2007, and this assessment identified the following significant deficiency in the company’s internal control over financial reporting:

Management’s policies are deficient in the following: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, and iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel

The management of Clovitech Inc.’s assessed the effectiveness of Clovitech, Inc.’s internal control over financial reporting as of December 31, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Based on our assessment and those criteria,

management believes that Clovitech, Inc. maintained effective internal control over financial reporting as of December 31, 2007.

Clovitech, Inc.'s independent registered public accounting firm has issued an audit report on its assessment of Clovitech, Inc.'s internal control over financial reporting.

Signed:

CEO of Clovitech, Inc.

CFO of Clovitech, Inc.

Case Materials for Adverse Condition:

Background on Clovitech, Inc.

Clovitech, Inc. is a mid-sized public company that manufactures computer accessories in the U.S. In 2007, the company reported sales revenues of \$400 million, and reported an overall profit of \$200 million for the year. The independent auditor for Clovitech, Inc. reported a "clean" opinion on the financial statements and an adverse opinion on internal controls over financial reporting for 2007. Clovitech, Inc. recently announced a restatement of their 2007 financial statements, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million. They disclosed that a material weakness in internal controls in the company was the leading cause of the significant inaccuracies in the 2007 financial statements. This weakness in internal controls allowed employees to falsely inflate revenue figures and conceal significant declines in demand for products. Less than two weeks after this restatement announcement, Clovitech, Inc. declared bankruptcy.

The following section details a timeline of the events leading up to the bankruptcy of Clovitech, Inc. The stockholders of Clovitech, Inc. are alleging that they relied on misleading disclosures made concerning the 2007 financial statements when they purchased stock in the period between the release of the 2007 financial statements and the restatement announcement in 2009. This group of shareholders is seeking to recover their losses from the managers, the audit committee, and/or the independent auditors. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14. Following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million. Please examine the events leading up to this bankruptcy to decide which parties should be sued to recover stockholder losses. Similar cases in the past have resulted in class action stockholder lawsuits against one or more parties, such as the company executives, the independent auditor, and the audit committee, alleging a range of offenses such as negligence, negligent misrepresentation, and fraud.

Events Surrounding Clovitech, Inc. Bankruptcy

January to March, 2008:

The independent auditor of Clovitech, Inc., a large international accounting firm that has performed independent audits for Clovitech, Inc. for 3 years, performs the audit of the 2007 financial statements and internal controls.

This audit is conducted under the requirements of the Sarbanes-Oxley Act of 2002, which requires independent auditors to conduct an evaluation of internal controls and release a report that communicates their findings. The Act also holds managers of public companies responsible for establishing and maintaining effective internal controls over financial reporting, and requires that an audit committee, consisting of members of the Board of Directors, oversee the audit process and resolve any issues that arise during the audit.

The independent auditor *identifies a significant deficiency in internal controls over inventory* indicating that the internal controls established by the top-level managers within the company may not be sufficient to prevent or detect material misstatements in the financial statements. Auditors are concerned that company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level.

The auditor *discloses their identification of a significant deficiency to the Audit Committee*. The deficiency is discussed in a meeting between the auditor, audit committee, and management to assess the likelihood that a material misstatement in the financial statements would not be prevented or detected because of the deficiency in internal controls.

Clovitech's managers argue that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures, but agree that there is reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of this deficiency. *Management decides to disclose a material weakness in internal controls within their report on internal controls, and to communicate that they have not maintained effective internal controls over financial reporting.*

The Audit Committee of Clovitech, Inc. supports management's decision and communicates their opinion to the auditor.

The independent auditor agrees with management and the audit committee that the deficiency in internal controls is not serious enough to question the reliability of the current financial statement figures. *The auditor decides NOT to modify their opinion on the 2007 financial statements, and to report that the 2007 financial statements are fairly stated.*

The independent auditor also agrees with management and the audit committee that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis because of the deficiency in internal controls over inventory. *The auditor decides to disclose a material weakness in internal controls within their*

report on internal controls, and to communicate that Clovitech, Inc. has not maintained effective internal controls over financial reporting.

March 13, 2008:

Clovitech, Inc. reports 2007 annual sales revenues of \$400 million and an overall profit of \$200 million for the year.

Management's report on internal controls over financial reporting states that Clovitech, Inc. *did not maintain effective internal control over financial reporting in 2007*. This report *contains a disclosure of a material weakness* in internal controls over inventory.

The auditor reports an *"adverse" opinion on internal controls*, stating that Clovitech, Inc. *did not maintain effective internal control over financial reporting in 2007*. This report *contains a disclosure of a material weakness* in internal controls over inventory.

The independent auditor for Clovitech, Inc., reports a *"clean" opinion on the financial statements* for 2007, stating that the *financial statements are fairly stated*.

March 13, 2008 to February 11, 2009:

After the release of the 2007 Annual Report, and prior to the restatement announcement, stockholders purchase a total of \$100 million in stock in Clovitech, Inc.

February 11, 2009:

Clovitech, Inc. *announces a restatement of their 2007 financial statements*, decreasing sales revenues by over \$200 million and resulting in an overall loss for the year of \$10 million.

Clovitech, Inc. discloses that the misstatement in their previous 2007 financial statements occurred *primarily due to a material weakness in internal controls over inventory*, stating that the internal controls established by the top-level managers within the company were ineffective. Specifically, company policy over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level. *This particular internal control issue was identified as a material weakness during the audit of the 2007 financial statements and internal controls, and was disclosed publicly within management's report on internal controls and the auditor's report on internal controls.*

Individual sales representatives in multiple regional offices have admitted to inflating revenues to meet projections and concealing significant declines in demand for their products for the past 18 months. The activity had been occurring since the beginning of 2007. *Because of the material weakness in internal controls over inventory, employees were able to falsely inflate sales revenues without being detected, resulting in a significant overstatement of sales revenues and profits in the financial statements of Clovitech, Inc. for 2007.*

Clovitech, Inc. *stock drops 50% in value* from \$28 to \$14 per share.

February 20, 2009:

Clovitech, Inc. files for Chapter 7 bankruptcy protection.

Clovitech, Inc. *stock is considered worthless*. The stockholders who purchased stock since the release of the 2007 financial statements are seeking advice about whether they have a case against the managers, independent auditor, and/or audit committee of Clovitech, Inc. to recover their estimated losses of \$100 million. *They believe that since they relied on misleading information in the 2007 financial statements and accompanying reports when purchasing the stock, they should be able to recover their losses.*

You have now concluded the case portion of this task.

Please return to the survey and click “Next” to continue to the next screen.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Clovitech, Inc.:

We have audited Clovitech, Inc. and subsidiaries’ (the “Company’s”) internal control over financial reporting as of December 31, 2007 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on that risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of

the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's consolidated annual or interim financial statements will not be prevented or detected on a timely basis.

The following material weakness has been identified and included in management's assessment:

The Company has not maintained an effective internal controls established by top management. Specifically, they have not maintained: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, and iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel

As a result of this deficiency, it is reasonably possible that internal controls over financial reporting may not have prevented or detected errors from occurring that could have been material, either individually or in the aggregate.

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the financial statements as of and for the year ended December 31, 2007, of the Company and this report does not affect our report on such financial statements.

In our opinion, because of the effect of the material weakness identified above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of December 31, 2007, based on the criteria

established in Internal Control— Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended December 31, 2007, of the Company and our report dated March 19, 2008 expressed an unqualified opinion on those financial statements.

Managing Partner
ABC CPA Firm

MANAGEMENT'S REPORT ON INTERNAL CONTROLS OVER FINANCIAL REPORTING

The management of Clovitech, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a – 15(f) and 15d – 15(f) under the Securities Exchange Act of 1934. Clovitech, Inc.'s internal control system is designed to provide reasonable assurance to Clovitech's management and board of directors regarding the reliability of financial reporting and the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects Clovitech, Inc.'s ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of Clovitech, Inc.'s financial statements that is more than inconsequential will not be prevented or detected by the Clovitech Inc.'s internal control. An internal control material weakness is a significant deficiency, or combination of them, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We considered the deficiency described in the paragraph below to be a material weakness in internal control over financial reporting. }

The management of Clovitech, Inc. assessed the effectiveness of the company's internal control over financial reporting as of December 31, 2007, and this assessment identified the following material weakness in the company's internal control over financial reporting:

Clovitech, Inc. has not maintained an effective internal controls established by top management. Specifically, they have not maintained: (i) a documented risk assessment process that adequately addresses COSO objectives, including strategic plans, budgets and clearly defined and communicated goals and objectives aligned with the assessment (ii) sufficient anti-fraud controls, such as the whistleblower program, communications, and training employees and the Board regarding fraud, (iii) adequate monitoring of existing controls over financial reporting and individual and corporate performance against expectations, and iv) appropriate human resource policies, such as background investigations and consistent performance reviews for key personnel

The management of Clovitech Inc.'s assessed the effectiveness of Clovitech, Inc.'s internal control over financial reporting as of December 31, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control—Integrated Framework. Because of the material weakness

described in the preceding paragraph, management believes that, as of December 31, 2007, the company's internal control over financial reporting was not effective based on those criteria.

Clovitech, Inc.'s independent registered public accounting firm has issued an audit report on its assessment of Clovitech, Inc.'s internal control over financial reporting.

Signed:

CEO of Clovitech, Inc.

CFO of Clovitech, Inc.

Questionnaire (Common across all conditions)

Please answer the following questions based on your perspective of the materials you reviewed.

Please indicate the likelihood (from 0-100%) that a lawsuit would be filed on behalf of the stockholders to recover damages from the following parties:

Note: Please enter a number for each between 0-100 with no decimals, and answer each question independently.

The managers/executives of the bankrupt company.

The independent auditor of the bankrupt company

The audit committee of the bankrupt company

Please answer the following questions based on your perspective of the materials you reviewed.

Please indicate your opinions about the strength of a potential case against the following parties:

	Extremely Strong Case	Somewhat Strong	Slightly Strong	Neither Strong or Weak	Slightly Weak	Somewhat Weak	Extremely Weak Case
The managers/executives of the bankrupt company.	0	0	0	0	0	0	0
The independent auditor of the bankrupt company.	0	0	0	0	0	0	0
The audit committee of the bankrupt company.	0	0	0	0	0	0	0

Please answer the following questions based on your perspective of the materials you reviewed. Assume that the stockholders are asking for advice about options to recover their losses.

*NOTE: These questions are not asking if YOU would take on this case, and are asking if you would recommend that the stockholders file a lawsuit and seek damages recover their losses.

Please indicate your agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
I would advise stockholders to file a lawsuit against the managers/executives of the bankrupt company to reclaim stockholder losses.	0	0	0	0	0	0	0
I would advise stockholders to file a lawsuit against the independent auditor to reclaim stockholder losses.	0	0	0	0	0	0	0
I would advise stockholders to file a lawsuit against the audit committee to reclaim stockholder losses.	0	0	0	0	0	0	0

Please indicate your agreement with the following statement. I would advise stockholders to file a lawsuit against the independent auditor, claiming the following:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
Ordinary negligence, under common law.	0	0	0	0	0	0	0
Negligent Misrepresentation, under common law.	0	0	0	0	0	0	0
Fraud, under common law.	0	0	0	0	0	0	0
Fraud, under securities law.	0	0	0	0	0	0	0

The following questions are asked to gain your perspectives on the strength of the stockholder's case against the auditors assuming that the stockholders decided to sue the auditor. Please indicate the degree to which you agree with the following statements.

If the auditors were sued for negligent misrepresentation under common law:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The audit firm would most likely settle out of court before proceeding to trial.	0	0	0	0	0	0	0
If the case went to a jury trial, the auditors would be found liable by the jury.	0	0	0	0	0	0	0
If auditors were found liable in a jury trial, the auditors would be instructed to compensate stockholders for their losses.	0	0	0	0	0	0	0
If auditors were found liable in a jury trial, the auditors would be instructed to pay punitive damages.	0	0	0	0	0	0	0
If the case went to a bench trial, the auditors would be found liable by the judge.	0	0	0	0	0	0	0
If auditors were found liable in a bench trial, the auditors would be instructed to compensate stockholders for their losses.	0	0	0	0	0	0	0
If auditors were found liable in a bench trial, the auditors would be instructed to pay punitive damages.	0	0	0	0	0	0	0

Would your answers to the above questions change if the auditor had been sued for *Securities Fraud* instead of *Negligent Misrepresentation*?

- Yes
- No

(If Yes)

If the auditors were sued for fraud:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The audit firm would most likely settle out of court before proceeding to trial.	0	0	0	0	0	0	0
If the case went to a jury trial, the auditors would be found liable by the jury.	0	0	0	0	0	0	0
If auditors were found liable in a jury trial, the auditors would be instructed to compensate stockholders for their losses.	0	0	0	0	0	0	0
If auditors were found liable in a jury trial, the auditors would be instructed to pay punitive damages.	0	0	0	0	0	0	0
If the case went to a bench trial, the auditors would be found liable by the judge.	0	0	0	0	0	0	0
If auditors were found liable in a bench trial, the auditors would be instructed to compensate stockholders for their losses.	0	0	0	0	0	0	0
If auditors were found liable in a bench trial, the auditors would be instructed to pay punitive damages.	0	0	0	0	0	0	0

The following question is designed to gauge your understanding of the information provided to you. Please answer the following to the best of your ability:

What did the independent auditors of Clovitech, Inc. conclude in their report on internal controls for the 2007 financial statements?

- The independent auditors concluded that internal controls were ineffective.
- The independent auditors concluded that internal controls were effective overall, but voluntarily disclosed one deficiency in internal controls that could become an issue.
- The independent auditors concluded that internal controls were effective, and did not disclose any deficiencies related to internal controls.

How realistic were the case materials?

- | | | | | | | |
|-------------------------|-------------------------|-------------------------|--|-----------------------|-----------------------|-------------------------|
| <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| not realistic
at all | somewhat
unrealistic | slightly
unrealistic | neither
realistic or
unrealistic | slightly
realistic | somewhat
realistic | completely
realistic |

In your review of the case, did you click on the link to view the auditor's report on internal controls, and view the information in the report?

- No Yes

The auditor's report on internal controls was relevant to my recommendations.

- | | | | | | | |
|-----------------------|-----------------------|-----------------------|------------------------------|-----------------------|-----------------------|-----------------------|
| <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| strongly
disagree | somewhat
disagree | slightly
disagree | neither agree
or disagree | slightly agree | somewhat
agree | strongly
agree |

In your review of the case, did you click on the link to view management's report on internal controls, and view the information in the report?

- No Yes

Management's report on internal controls was relevant to my recommendations.

- | | | | | | | |
|-----------------------|-----------------------|-----------------------|------------------------------|-----------------------|-----------------------|-----------------------|
| <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> | <input type="radio"/> |
| strongly
disagree | somewhat
disagree | slightly
disagree | neither agree
or disagree | slightly agree | somewhat
agree | strongly
agree |

The following questions are asked to allow the researchers to further understand the demographics of the individuals responding to this study. The answers are entirely voluntary, but are very important to the research.

What is your age?

What is your gender?

- Male Female

What is your current state of residence?

Have you ever received a college degree with a major or minor in business?

- No Yes

If yes, please specify what degree:

Which of the following apply to the level of post-undergraduate education that you have completed: (Please check ALL that apply)

- Juris Doctor Degree (JD) MBA JD/MBA Joint Degree
 JD/MA Joint Degree Master's Degree in Accounting Other (Please specify in the text box below)
 Master's Degree in Law (LLM) Master's Degree in Tax

If other, please specify:

How would you rate your level of knowledge of securities litigation?

- Extremely High Somewhat High Slightly High Neither High or Low Slightly Low Somewhat Low

How would you rate your level of experience in securities litigation?

- Extremely High Somewhat High Slightly High Neither High or Low Slightly Low Somewhat Low

Are you a practicing attorney?

- No, I have never been a practicing attorney.
 Yes.
 No, I am retired or no longer in practice.
 No, I am not currently practicing but am in process of looking for a job.
 No, I am not currently practicing but am working as a law instructor/professor.

In what state(s) have you been a practicing attorney?

How many years' experience do you have as a practicing attorney?

Please estimate the percentage of time you have spent in your career on the following types of cases (Please enter a number from 0-100 in each box. The total of all three should equal 100%):

Civil Actions % _____

Criminal Actions % _____

Other Legal Matters % _____

Have you ever been professionally involved in a lawsuit where the auditor of a company was sued? (*NOTE: Please check ALL that apply)

No _____

Yes, working for the defense team (auditor) _____

Yes, working for the plaintiff team _____

If other, please specify _____

What is (are) your area(s) of specialty? (*NOTE: Please check ALL that apply)

Bankruptcy Law _____

Business Law _____

Tort Litigation _____

Securities Law _____

Class Actions _____

Professional Liability _____

If other, please specify _____

Are you currently or have you ever been:

A member of the National Association of Bankruptcy Trustees?

A member of the American Bar Association?

A Certified Public Accountant (CPA)?

An Auditor?

A Manager in a business where a financial audit was conducted?

A Certified Financial Analyst (CFA)

A Professional Investor (provided investment advice or made investments for others as your main source of employment)?

A Member of an Audit Committee or Board of Directors for a Public Company?

You have now finished the study.

APPENDIX C: STUDY 2 CASES AND QUESTIONNAIRE

Entry Page to Study

Researchers at the University of Central Florida (UCF) study many topics. To do this we need the help of people who agree to take part in a research study. You are being invited to participate in a research project conducted by Jillian Phillips, CPA and Vicky Arnold, PhD, of the University of Central Florida's Dixon School of Accounting. You can ask questions about the research. You can read this form and agree to take part right now, or return to this page and complete the study at a later time. You will be told if any new information is learned which may affect your willingness to continue taking part in this study.

You have been asked to take part in this research study because you represent the qualities of a person who could be selected to be jury member. You must be 18 years of age or older to be included in the research study and continue past this screen. You will be asked to answer questions that will take about 20-30 minutes of your time. There are no expected risks for taking part in this study. You do not have to answer every question or complete every task. You may skip any questions or tasks. You do not have to answer any questions that make you feel uncomfortable.

A student at the University of Central Florida provided your email address as part of an extra credit assignment in their course, indicating that you would be interested in participating in the study. There is no additional compensation, payment or extra credit for taking part in this study. Your participation in this study is entirely voluntary, and you do not need to take any further actions for the student to receive their extra credit. The student who provided your contact information to us has already received extra credit just for helping recruit qualified participants for the study, and by obtaining permission to provide us with your contact information so that we could invite you to participate in the study. The student's help in the recruiting process was of great value to the study, as this study is being conducted as a part of my dissertation to graduate with my PhD from the University of Central Florida.

The overall purpose of this study is to understand how individuals make decisions when they are chosen to be jury members in a court case. Specifically, I am looking at court cases involving class action shareholder lawsuits against auditors. You are being invited to participate because you represent individuals who could be chosen to be a jury member, and your opinions are important to gaining understanding how jurors make decisions. You will be provided with information about a court case scenario and will be asked to provide your opinions from the viewpoint of a jury member. You do not need to have any prior knowledge about the task to complete the survey. This questionnaire includes a description of a scenario that a member on a jury may encounter. After reading the scenario, you will be asked several questions regarding what you would do if you were a jury on the trial as well as your opinions about different factors related to the trial.

Please note that this is an academic study conducted at a university to gain insight into attitudes about auditor liability. As the results of this study could be helpful to policymakers and auditors, it is important that you answer each question in a serious and thoughtful

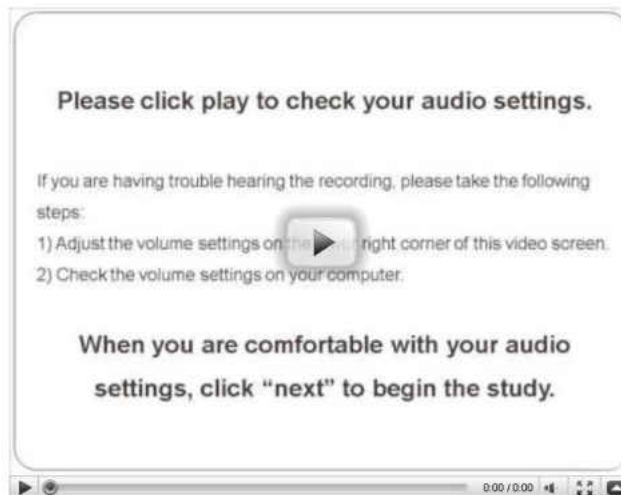
manner. You may benefit from participating in this study by gaining a further understanding of how court cases are tried, and the laws that govern auditor liability in the U.S.

This study is anonymous. That means that no one, not even members of the research team, will know that the information you gave came from you. Your name will not be collected or associated in any way with your responses, and only aggregated data will be included in any resulting publication or presentations. The study is conducted entirely online using a dependable and secure online survey website.

You must be at least 18 years of age to participate in this study. You should take part in this study only because you want to. There is no penalty for not taking part. You have the right to stop at any time by closing the window on your computer screen. You will be told if any new information is learned which may affect your willingness to continue taking part in this study. This study does not include any audio or video taping. If you have any questions regarding this project, you may contact Jillian Phillips at (407)-435-0493 or by email at jphillips@bus.ucf.edu, or Dr. Arnold at (407) 823-3192 or by email at varnold@bus.ucf.edu. Questions or concerns about research participants' rights may be directed to the UCFIRB office, University of Central Florida, Office of Research & Commercialization, 12201 Research Parkway, Suite 501, Orlando, FL 32826-3246. The phone number is (407)-823-2901.

IF YOU DO NOT SEE A NAVIGATION BAR FOR AUDIO BELOW YOU WILL NEED VERIFY THAT YOU HAVE THE FOLLOWING SOFTWARE ON YOUR COMPUTER:

Macromedia Flash Player 7.0+ plug-in
Windows 2000 or higher with latest updates installed
Mac OS X 10.3 or higher
Firefox 1.1+, Internet Explorer 5.0+, or Safari 1.0+
Broadband connection with 500+ Kbps
If you have these software versions and still are not able to view the video, [Click Here](#) for troubleshooting options



Not Disclosed/Less Auditable Condition:

Introduction to Study

The following section provides an overview of a realistic court case that emerged following the bankruptcy of a public company. A large group of individuals who own stock in the company filed a class action suit against the auditors for negligent misrepresentation, and are seeking damages to recover losses in stock value. The circumstances of the case will be argued from the perspectives of both the plaintiff and defendant.

While reviewing the information presented to you, we ask that you evaluate the information as if you were a jury member assigned to the trial. After you review the information, you will be asked to conclude whether the independent auditor, ABC CPA Firm, is liable for negligent misrepresentation, and provide your opinions about the circumstances presented in the case.

Stockholders of Clovitech, Inc. v. ABC CPA Firm

Complaint: The plaintiffs, the stockholders of Clovitech, Inc., allege that the defendant, ABC CPA Firm, made false statements without exercising reasonable care of competence in obtaining and communicating information for the audit of the 2007 financial statements and internal controls of Clovitech, Inc. They are suing ABC CPA Firm, a large international accounting firm, for \$100 million in damages for their actual losses in stock value, and are asking for additional punitive damages to punish ABC CPA Firm for their negligent actions.

Response: The defendant, ABC CPA Firm, responds that it fully complied with auditing standards and that it was not negligent in obtaining or communicating information related to the audit of the 2007 financial statements of Clovitech, Inc.

END OF INTRODUCTION

Please click "Next" to continue to the Plaintiff Arguments

Plaintiff Arguments

This case is about auditor negligence. You are about to find out what can happen when auditors do not do their jobs properly, and stockholders lose millions of dollars as a result. Auditors are hired by companies to determine whether the **financial statements** of the company are **accurate**. Auditors also investigate whether the company has proper **internal control** policies in place, which are policies within a company that are established to either **prevent or detect** significant **inaccuracies** in the financial statements (for example: restricting access to bookkeeping functions and computer systems or requiring managers to approve large transactions).

In this case, ABC CPA Firm, the auditors of Clovitech, Inc. for the past three years, discovered an issue in the **internal controls established by the top level managers** within the company during their audit of Clovitech Inc. for the 2007 financial statements. However, ABC CPA Firm decided that the issue wasn't important, and concluded that the **internal controls** within Clovitech, Inc. were **effective** (otherwise known as a "clean" opinion on internal controls).

Their "clean" opinion on internal controls was **misleading**, and **did not contain any disclosure** of the deficiency in internal controls that the auditors discovered during their audit. In fact, this particular internal control deficiency, a **lack of sufficient internal controls established by the top level managers** within the company was the **leading cause of the company's bankruptcy in 2009**.

Because of ABC CPA Firm's **failure to properly investigate the impact of the deficiency in internal controls**, and their **failure to communicate the potential issue in Clovitech's internal controls to the public**, stockholders of Clovitech, Inc. lost \$100 million when the company's stock became worthless after the bankruptcy. The stockholders of Clovitech, Inc. are suing the auditor, ABC CPA Firm, for **\$100 million** in damages for their actual losses, and are asking for **additional punitive damages** to punish ABC CPA Firm for their negligent actions.

Although auditors are hired and paid by the companies whose financial statements they examine, an **auditor's primary duty is to the general public**. Investors and creditors often rely on the auditor's opinion on the financial statements and internal controls when deciding if they can trust the financial information released by the company, which can greatly influence their investment/lending decisions. In this case, **the stockholders of Clovitech, Inc. relied on ABC CPA Firm's reports when deciding to purchase stock in the company**.

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed **sales revenues of \$400 million**, and reported an overall profit of **\$200 million for the year**. ABC CPA Firm reported that the 2007 **financial statements** of Clovitech, Inc. were **accurate**. More importantly, the auditors reported that the internal

controls within the company were sufficient to assure reliance on their financial figures. Relying on this information provided by Clovitech, Inc. and ABC CPA Firm, stockholders purchased and retained stock in the company totaling \$100 million.

In February 2009, almost a year after ABC CPA Firm released these reports, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme had emerged, and it became evident that employees had been inflating sales revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock Clovitech, Inc. products by providing incentives (for example: highly favorable credit terms of 6 months or more with no interest). The sales were then recorded as income for Clovitech, Inc. The scheme was uncovered when demand for the product declined. Retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated sales revenue figures.

The discovery that this significant overstatement of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year.

The restatement was also accompanied by management's disclosure of a serious flaw in internal controls, stating that the internal controls established by the top level managers within the company were ineffective. Company policy over-emphasized meeting short term profit goals at the sacrifice of internal control at the sales division level. This weakness in internal control contributed to the fact that the employees were able to falsely inflate sales revenue figures without being detected.

On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders of Clovitech, Inc. are not arguing that ABC CPA Firm would have necessarily discovered the actual fraud if they had performed additional procedures. It is well known that managers will go to great lengths to cover up fraudulent activity. Instead, the stockholders argue that the auditors were negligent in their evaluation of internal controls within the company, and that their disclosures were misleading.

The lack of appropriate internal controls in place at Clovitech, Inc. permitted fraudulent activity to occur within the company on a continuing basis. This fraudulent activity resulted in financial statements that were not reliable, with sales revenue figures falsely inflated by over \$200 million. This overstatement in sales revenue is a serious issue, because stockholders may not have purchased stock in the company if these false sales were not included in the company's income.

Workpaper evidence indicates that ABC CPA Firm identified the deficiency in the internal controls established by the top level managers within the company that facilitated this fraudulent activity.

Although the auditor will argue that they performed additional audit procedures to confirm that the deficiency they found was not likely to cause major issues with the financial statement figures, they chose not to disclose any information to the public on their findings, and reported that internal controls were effective in the company. This overall conclusion on internal controls was misleading.

We argue that the type of evidence the auditor relied upon in this case to evaluate internal controls, employee interviews, was not sufficient evidence to reach their conclusions and allowed the auditor too much leeway in interpretation. Interview evidence is highly subjective, and the auditor relied heavily on professional judgment to form their opinions. How are we to know that the auditor performed their duties with care when they interpreted the interview evidence? They may have been biased against finding anything that would make more work for them or cause them to lose the client for next year's audit. Auditors are paid to provide their services to companies. How can we rely so heavily on the auditor's judgment when they are financially motivated to keep their job?

Overall, the auditor's opinion on internal controls mislead investors into thinking there were no problems with the internal controls of the company, when in fact auditors were aware of deficiencies. The auditor did not publicly disclose any concerns with the company's controls. Instead, they reported a "clean" opinion on internal controls, expressing that controls within the company were "effective". At the very least, auditors could have voluntarily disclosed the deficiencies they found to provide some type of warning to investors about the problems within the company.

We claim that, because of their **negligence** and resulting **misleading statement** within their **audit opinion on internal controls**, the auditor **did not signal investors** of the true potential that the financial statements may not be accurate. Therefore, I am asking on behalf of the stockholders of Clovitech, Inc. that you find ABC CPA Firm liable for **negligent misrepresentation**. We ask that you compensate the stockholders **\$100 million** for the loss in stock value, and that you punish the auditors appropriately by awarding **punitive damages** as well.

END OF PLAINTIFF ARGUMENTS

Please click "Next" to continue to the Defendant's Arguments

Defendant Arguments

Our position is that ABC CPA Firm **fully complied with auditing standards** in its audit of Clovitech, Inc.'s 2007 financial statements and internal controls. We argue that ABC CPA Firm **should not be liable for negligent misrepresentation**. To help you understand why the auditor's actions were in fact **not negligent**, I would like to first give you a short background on what the auditor's responsibilities are in the financial reporting process.

Then, I will provide specific details about the 2007 audit of Clovitech, Inc.'s **internal controls** to show that the auditor performed **well within the duty of care** required by the **audit standards** in the U.S. After you hear these facts, you will no doubt find that ABC CPA Firm should be found **not liable** for **negligent misrepresentation**.

An auditor's job is to reduce the probability that people receive misstated financial statements, but **auditors cannot provide 100% assurance that financial statements are accurate**. Auditors could potentially find every misstatement, but to do so they would have to examine every single transaction in which a company took part. This would make the cost of an audit so high that no one would be able to afford an audit at all. Instead, auditors examine a subset of transactions by using their professional judgment and sophisticated sampling techniques. This is what auditing standards require.

The auditor also conducts an **evaluation of internal controls** to determine if the company has controls in place to prevent the employees from committing fraud and/or making errors. Since the auditor cannot possibly look at every transaction, high quality internal controls are important because **they provide additional assurance that a company's financial statements are accurate**. During this process, the auditor frequently identifies deficiencies

in internal controls, particularly with a company this size, which could have an excellent system of internal controls but still end up with hundreds of small ways that fraud could be committed.

Most of the time, these deficiencies are deemed to be immaterial, in the sense that they will not likely lead to large discrepancies in the financial statement figures. These deficiencies are privately disclosed to the company so that they can improve internal controls, and many times the company is able to resolve the issue before it becomes a problem. However, **unless the auditor believes that an unresolved deficiency could lead to a large error in the financial statements, audit standards do not require that auditors modify their opinions about the company's financial statements and internal controls, and they are not required to disclose anything about the deficiencies to the public.**

The plaintiff is arguing that if the auditor had performed procedures correctly, they would have known that there was an increased risk of error and fraud in the company, and would have modified their opinion accordingly. Unfortunately, the decisions made by auditors are not always black and white. It is well known in the professional community that the **audit of internal controls is a difficult process** that requires auditors to rely heavily on their professional judgment and instincts in certain situations. At times, there isn't solid evidence that the auditor can collect to support their judgments.

In this particular situation, during their audit of the 2007 financial statements and internal controls of Clovitech, Inc., ABC CPA Firm discovered and documented **334 internal control deficiencies** in various areas in the company, an average amount for a company of this size. All of these deficiencies were either corrected by Clovitech, Inc. or the auditor decided that the deficiency was not likely to expose the company to large errors in the financial statements.

One of these **334** deficiencies was in the **internal controls established by top level management**. This deficiency was identified when the auditor **performed interviews** with a sample of sales representatives from three different offices to gain an understanding of the general attitude of upper level management. Only **one** sales representative, of the employees interviewed, indicated that **management was overly focused on meeting sales projections**, and **would not care if the revenue figures were inflated** as long as the projections were met.

ABC CPA Firm immediately identified this as a significant deficiency in internal controls and documented the findings in their workpapers. To see whether the deficiency could be a larger issue, the auditor expanded their sample to interview an **additional sample of employees** and found **no other indication** that the employees felt pressured to inflate their revenue figures. In their routine procedures to test for the accuracy of revenue figures, the auditor **also** examined a sample of **sales transactions**, and found them all to be **legitimate sales**.

Based on this evidence, ABC CPA Firm decided that this **deficiency in the internal controls**

established by top management would *not* be likely to cause a *material misstatement* of the *financial statements*. The auditor relied on this evidence and their own professional judgment in this case to formulate their opinions about the deficiency.

Although the plaintiff argues that the auditor did not perform enough procedures to properly assess the impact of this internal control issue, we argue that the auditor operated within audit standards and documented their findings accordingly. They concluded, based on the evidence at the time, that there was *not a material weakness in internal controls*. This means that they do not believe that the deficiency would be bad enough to potentially lead to a significant error in the financial statement figures.

Based on this conclusion and audit standards, the auditor had *no responsibility to disclose any information* on the internal control deficiency at all. Therefore, the auditors' *failure to disclose* the deficiency publicly is *completely irrelevant* to this case, as auditors are *not required by audit standards to disclose internal control deficiencies* if they are not deemed material weaknesses. Any additional disclosure of internal control deficiencies is considered *entirely optional*.

To put this into perspective, this was *the only* deficiency, *out of 334*, where the auditor's judgment turned out to be inaccurate in hindsight. If we think in broader terms about how many deficiencies an audit firm will identify each year across all of their clients in the U.S., this is *one deficiency out of thousands*. No person should ever be held to such a standard of perfection, especially when they clearly performed their job within the standard guidelines of the profession.

Negligent misrepresentation 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. The auditor being sued in this case *clearly performed the appropriate audit procedures to evaluate internal controls*. The auditor was *not required by auditing standards* to say *anything at all* about the deficiency within the report. It is the defense's position that if an auditor complies with auditing standards, he has not been negligent. Has the plaintiff proven that this is a case of negligent misrepresentation on the part of the auditor? Absolutely not.

END OF DEFENDANT ARGUMENTS

Please click "Next" to continue to the Closing Statements

Closing Statements

Plaintiff Closing Statement

Society expects more than this from auditors. We expect auditors to maintain an attitude of professional skepticism in dealing with their clients. We expect auditors to take any irregularities in their clients' internal control procedures seriously, as such measures are in place to prevent fraudulent activities such as the ones that led to material misstatements in Clovitech, Inc.'s financial statements.

The auditor admits that an employee of Clovitech raised a concern about **the internal controls established by top management**, but the auditor dismissed the individual on the basis that other employees didn't feel the same way. Did they stop to think that the people they are interviewing are likely to be the exact people perpetrating fraud? Of course, the auditor **relied on professional judgment** to make their decision, but how are we to know whether they made this judgment responsibly and not out of their own self interest?

Auditors are being paid to perform their services, and have been known to downplay issues they find so that they are hired again for the next year. In conclusion, ABC CPA Firm clearly did not live up to society's expectations, and should be held accountable for their actions. Because of the auditor's negligent actions, the **stockholders lost \$100 million** through their investment. Therefore, I urge you to find ABC CPA Firm liable for negligent misrepresentation. I also urge you to require the auditors to compensate these stockholders for their losses, and punish the auditors for not doing their job.

Defendant Closing Statement

The plaintiff has told you that ABC CPA Firm made some mistakes in its audit of the 2007 financial statements of Clovitech, Inc., specifically in their evaluation of internal controls. It is now up to you to evaluate whether the actions taken by ABC CPA Firm were actually negligent, according to the laws and regulations established in the U.S. Is it negligent to follow **commonly-used judgmental procedures** in determining the impact of internal control deficiencies? Is it negligent to **follow reporting guidelines** and **only disclose internal control issues** that are deemed by the auditor to be material?

This is clearly **not** a case of **negligent misrepresentation**; moreover, auditing standards require nothing more than these actions. The fact of the matter is that ABC CPA Firm made a difficult decision when evaluating whether the deficiency in the **internal controls established by top management** at Clovitech, Inc. could create **material errors in the financial statements**.

It is well known in practice that this particular control deficiency is very difficult to evaluate because it **requires the auditor to rely on their perceptions** about a situation **based on interviews**. If the auditor had the ability to collect additional evidence in this case that would

allow them to rely less on individual perceptions, they certainly would have done so. However, this is not the case, because evaluating the internal controls established by top management is very subjective, and the auditor was forced to make a decision based on their professional judgment about the situation. It is not the auditor's fault that they could not collect other types of evidence that would rely less on their professional judgment. The evidence the auditor collected clearly indicated to them at the time that there wasn't a larger issue with the account.

The fact that their opinion was wrong is irrelevant; audits cannot possibly assure that the financial statements are 100% accurate. ABC CPA Firm performed an audit that complies with auditing standards. It is clear that ABC CPA Firm is not liable for negligent misrepresentation. The plaintiff has failed to demonstrate otherwise. Accordingly, I urge you to find ABC CPA Firm not liable for negligent misrepresentation.

END OF CLOSING STATEMENTS

Please click "Next" to continue to the Judge's Instructions

Not Disclosed/More Auditable Condition

Introduction to Study

The following section provides an overview of a realistic court case that emerged following the bankruptcy of a public company. A large group of individuals who own stock in the company filed a class action suit against the auditors for negligent misrepresentation, and are seeking damages to recover losses in stock value. The circumstances of the case will be argued from the perspectives of both the plaintiff and defendant.

While reviewing the information presented to you, we ask that you evaluate the information as if you were a jury member assigned to the trial. After you review the information, you will be asked to conclude whether the independent auditor, ABC CPA Firm, is liable for negligent misrepresentation, and provide your opinions about the circumstances presented in the case.

Stockholders of Clovitech, Inc. v. ABC CPA Firm

Complaint: The plaintiffs, the stockholders of Clovitech, Inc., allege that the defendant, ABC CPA Firm, made false statements without exercising reasonable care of competence in obtaining and communicating information for the audit of the 2007 financial statements and internal controls of Clovitech, Inc. They are suing ABC CPA Firm, a large international

accounting firm, for **\$100 million in damages** for their actual losses in stock value, and are asking for additional **punitive damages** to punish ABC CPA Firm for their negligent actions.

Response: The defendant, ABC CPA Firm, responds that it **fully complied with auditing standards** and that it was **not negligent** in **obtaining or communicating** information related to the audit of the 2007 financial statements of Clovitech, Inc.

END OF INTRODUCTION

Please click "Next" to continue to the Plaintiff Arguments

Plaintiff Arguments

This case is about auditor negligence. You are about to find out what can happen when auditors do not do their jobs properly, and stockholders lose millions of dollars as a result. Auditors are hired by companies to determine whether the **financial statements** of the company are **accurate**. Auditors also investigate whether the company has proper **internal control** policies in place, which are policies within a company that are established to either **prevent or detect** significant **inaccuracies** in the financial statements (for example: restricting access to bookkeeping functions and computer systems or requiring managers to approve large transactions).

In this case, ABC CPA Firm, the auditors of Clovitech, Inc. for the past three years, discovered an issue in the **internal controls for tracking and reporting inventory** during their audit of Clovitech Inc. for the 2007 financial statements. However, ABC CPA Firm decided that the issue wasn't important, and concluded that the **internal controls** within Clovitech, Inc. were **effective** (otherwise known as a "clean" opinion on internal controls).

Their "clean" opinion on internal controls was **misleading**, and **did not contain any disclosure** of the deficiency in internal controls that the auditors discovered during their audit. In fact, this particular internal control deficiency, a **lack of sufficient internal controls for tracking and reporting inventory**, was the **leading cause of the company's bankruptcy in 2009**.

Because of ABC CPA Firm's **failure to properly investigate the impact of the deficiency in internal controls**, and their **failure to communicate the potential issue in Clovitech's internal controls to the public**, stockholders of Clovitech, Inc. lost \$100 million when the company's stock became worthless after the bankruptcy. The stockholders of Clovitech, Inc. are suing the auditor, ABC CPA Firm, for **\$100 million** in damages for their actual losses,

and are asking for **additional punitive damages** to punish ABC CPA Firm for their negligent actions.

Although auditors are hired and paid by the companies whose financial statements they examine, an **auditor's primary duty is to the general public**. Investors and creditors often rely on the auditor's opinion on the financial statements and internal controls when deciding if they can trust the financial information released by the company, which can greatly influence their investment/lending decisions. In this case, **the stockholders of Clovitech, Inc. relied on ABC CPA Firm's reports when deciding to purchase stock in the company.**

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed **sales revenues of \$400 million**, and reported an overall profit of **\$200 million for the year**. ABC CPA Firm reported that the 2007 **financial statements** of Clovitech, Inc. were **accurate**. More importantly, the auditors reported that the internal controls within the company **were sufficient** to assure **reliance on their financial figures**. Relying on this information provided by Clovitech, Inc. and ABC CPA Firm, stockholders purchased and retained stock in the company totaling **\$100 million**.

In February 2009, almost a year after ABC CPA Firm released these reports, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 **bankruptcy** due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme had emerged, and it became evident that employees had been **inflating sales revenues** to meet projections and **conceal significant declines in demand** for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock Clovitech, Inc. products by providing incentives (for example: highly favorable credit terms of 6 months or more with no interest). The sales were then recorded as income for Clovitech, Inc. The scheme was uncovered when **demand for the product declined**. Retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on **intentionally manipulated sales revenue figures**.

The discovery that this significant overstatement of sales revenue figures had been occurring since the beginning of 2007 prompted the company to **decrease** their 2007 reported **sales revenues** by **over \$200 million**, resulting in an **overall loss of \$10 million for the year**.

The restatement was also accompanied by management's disclosure of a serious flaw in internal controls, stating that the **internal controls for tracking and reporting inventory** are ineffective and resulted in unreliable monitoring of inventory counts and demands. **This weakness in internal control contributed to the fact that the employees were able to falsely**

inflate sales revenue figures without being detected.

On the day the **restatement** was announced, Clovitech, Inc. stock **dropped 50%** in value from **\$28 to \$14** per share. Only one week later, following the **bankruptcy** announcement, the stock was considered **worthless**, with total losses for this group of shareholders estimated at **\$100 million**.

The stockholders of Clovitech, Inc. are **not** arguing that ABC CPA Firm would have necessarily discovered the **actual fraud** if they had performed additional procedures. It is well known that managers will go to great lengths to cover up fraudulent activity. Instead, the stockholders argue that the auditors were negligent in their **evaluation of internal controls** within the company, and that their **disclosures were misleading**.

The **lack of appropriate internal controls** in place at Clovitech, Inc. **permitted fraudulent activity to occur** within the company on a continuing basis. This fraudulent activity resulted in financial statements that were not reliable, with **sales revenue** figures falsely inflated by over **\$200 million**. This overstatement in sales revenue is a serious issue, because stockholders may not have purchased stock in the company if these false sales were not included in the company's income.

Workpaper evidence indicates that ABC CPA Firm identified the deficiency in the **internal controls for tracking and reporting inventory** that **facilitated this fraudulent activity**.

Although the auditor will argue that they performed additional audit procedures to confirm that the deficiency they found was not likely to cause major issues with the financial statement figures, they **chose not to disclose** any information to the public on their findings, and reported that **internal controls** were **effective** in the company. This overall conclusion on internal controls was **misleading**.

We argue that the **type of evidence** the auditor relied upon in this case to evaluate internal controls, **statistical sampling of transactions**, was **not sufficient** evidence to reach their conclusions. This evidence only **represents a small subset** of all of the transactions in the company. How are we to know that the auditor performed their duties with care when they examined the evidence they collected? They may have been biased against finding anything that would make more work for them or cause them to lose the client for next year's audit. Auditors are paid to provide their services to companies. How can we rely so heavily on the auditor's judgment when they are financially motivated to keep their job?

Overall, the **auditor's opinion on internal controls mislead investors** into thinking there were no problems with the internal controls of the company, when in fact auditors were aware of deficiencies. The auditor **did not publicly disclose** any concerns with the company's controls. Instead, they reported a "clean" opinion on internal controls, expressing that **controls within the company were "effective"**. At the very least, auditors **could have voluntarily disclosed the deficiencies** they found to provide some type of warning to

investors about the problems within the company.

We claim that, because of their **negligence** and resulting **misleading statement** within their **audit opinion on internal controls**, the auditor **did not signal investors** of the true potential that the financial statements may not be accurate. Therefore, I am asking on behalf of the stockholders of Clovitech, Inc. that you find ABC CPA Firm liable for **negligent misrepresentation**. We ask that you compensate the stockholders **\$100 million** for the loss in stock value, and that you punish the auditors appropriately by awarding **punitive damages** as well.

END OF PLAINTIFF ARGUMENTS

Please click "Next" to continue to the Defendant's Arguments

Defendant Arguments

Our position is that ABC CPA Firm **fully complied with auditing standards** in its audit of Clovitech, Inc.'s 2007 financial statements and internal controls. We argue that ABC CPA Firm **should not be liable for negligent misrepresentation**. To help you understand why the auditor's actions were in fact **not negligent**, I would like to first give you a short background on what the auditor's responsibilities are in the financial reporting process.

Then, I will provide specific details about the 2007 audit of Clovitech, Inc.'s **internal controls** to show that the auditor performed **well within the duty of care** required by the **audit standards** in the U.S. After you hear these facts, you will no doubt find that ABC CPA Firm should be found **not liable** for **negligent misrepresentation**.

An auditor's job is to reduce the probability that people receive misstated financial statements, but **auditors cannot provide 100% assurance that financial statements are accurate**. Auditors could potentially find every misstatement, but to do so they would have to examine every single transaction in which a company took part. This would make the cost of an audit so high that no one would be able to afford an audit at all. Instead, auditors examine a subset of transactions by using their professional judgment and sophisticated sampling techniques. This is what auditing standards require.

The auditor also conducts an **evaluation of internal controls** to determine if the company has controls in place to prevent the employees from committing fraud and/or making errors. Since the auditor cannot possibly look at every transaction, high quality internal controls are important because **they provide additional assurance that a company's financial statements are accurate**. During this process, the auditor frequently identifies deficiencies

in internal controls, particularly with a company this size, which could have an excellent system of internal controls but still end up with hundreds of small ways that fraud could be committed.

Most of the time, these deficiencies are deemed to be immaterial, in the sense that they will not likely lead to large discrepancies in the financial statement figures. These deficiencies are privately disclosed to the company so that they can improve internal controls, and many times the company is able to resolve the issue before it becomes a problem. However, **unless the auditor believes that an unresolved deficiency could lead to a large error in the financial statements, audit standards do not require that auditors modify their opinions about the company's financial statements and internal controls, and they are not required to disclose anything about the deficiencies to the public.**

The plaintiff is arguing that if the auditor had performed procedures correctly, they would have known that there was an increased risk of error and fraud in the company, and would have modified their opinion accordingly. Unfortunately, the decisions made by auditors are not always black and white. It is well known in the professional community that the **audit of internal controls is a difficult process** that requires auditors to rely heavily on their professional judgment and instincts in certain situations. At times, there isn't solid evidence that the auditor can collect to support their judgments.

In this particular situation, during their audit of the 2007 financial statements and internal controls of Clovitech, Inc., ABC CPA Firm discovered and documented **334 internal control deficiencies** in various areas in the company, an average amount for a company of this size. All of these deficiencies were either corrected by Clovitech, Inc. or the auditor decided that the deficiency was not likely to expose the company to large errors in the financial statements.

One of these **334** deficiencies was in the **internal controls for tracking and recording inventory**. This deficiency was identified when the auditor **examined inventory records** at three different offices to make sure that employees were tracking and recording inventory properly. Only **one** record, out of the records examined, indicated **that inventory counts and records may not be consistently updated and errors may not be resolved.**

ABC CPA Firm immediately identified this as a **significant deficiency** in internal controls and documented the findings in their workpapers. To see whether the deficiency could be a larger issue, the auditor expanded their sample to examine an **additional sample of records** and found **no other indication** that the inventory count and record keeping procedures were deficient. In their routine procedures to test for the accuracy of revenue figures, the auditor **also** examined a **sample of sales transactions**, and found them all to be **legitimate sales**.

Based on this evidence, ABC CPA Firm decided that this **deficiency in the internal controls over inventory procedures** would **not** be likely to cause a **material misstatement** of the **financial statements**. The auditor relied on this evidence to formulate their opinions about

the deficiency.

Although the plaintiff argues that the auditor did not perform enough procedures to properly assess the impact of this internal control issue, we argue that the auditor operated within audit standards and documented their findings accordingly. They concluded, based on the evidence at the time, that there was not a material weakness in internal controls. This means that they do not believe that the deficiency would be bad enough to potentially lead to a significant error in the financial statement figures.

Based on this conclusion and audit standards, the auditor had no responsibility to disclose any information on the internal control deficiency at all. Therefore, the auditors' failure to disclose the deficiency publicly is completely irrelevant to this case, as auditors are not required by audit standards to disclose internal control deficiencies if they are not deemed material weaknesses. Any additional disclosure of internal control deficiencies is considered entirely optional.

To put this into perspective, this was the only deficiency, out of 334, where the auditor's judgment turned out to be inaccurate in hindsight. If we think in broader terms about how many deficiencies an audit firm will identify each year across all of their clients in the U.S., this is one deficiency out of thousands. No person should ever be held to such a standard of perfection, especially when they clearly performed their job within the standard guidelines of the profession.

Negligent misrepresentation 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. The auditor being sued in this case clearly performed the appropriate audit procedures to evaluate internal controls. The auditor was not required by auditing standards to say anything at all about the deficiency within the report. It is the defense's position that if an auditor complies with auditing standards, he has not been negligent. Has the plaintiff proven that this is a case of negligent misrepresentation on the part of the auditor? Absolutely not.

END OF DEFENDANT ARGUMENTS

Please click "Next" to continue to the Closing Statements

Closing Statements

Plaintiff Closing Statement

Society expects more than this from auditors. We expect auditors to maintain an attitude of professional skepticism in dealing with their clients. We expect auditors to take any irregularities in their clients' internal control procedures seriously, as such measures are in place to prevent fraudulent activities such as the ones that led to material misstatements in Clovitech, Inc.'s financial statements.

The auditor admits that they found evidence of a discrepancy in the inventory records, but the auditor dismissed it on the basis that they didn't find any other discrepancies. Did they stop to think that there may be many more discrepancies in the account that they didn't even look at? Of course, the auditor relied on statistics to evaluate the potential for bigger issues in the company, but how are we to know they made this judgment responsibly and not out of their own self interest?

Auditors are being paid to perform their services, and have been known to downplay issues they find so that they are hired again for the next year. In conclusion, ABC CPA Firm clearly did not live up to society's expectations, and should be held accountable for their actions. Because of the auditor's negligent actions, the stockholders lost \$100 million through their investment. Therefore, I urge you to find ABC CPA Firm liable for negligent misrepresentation. I also urge you to require the auditors to compensate these stockholders for their losses, and punish the auditors for not doing their job.

Defendant Closing Statement

The plaintiff has told you that ABC CPA Firm made some mistakes in its audit of the 2007 financial statements of Clovitech, Inc., specifically in their evaluation of internal controls. It is now up to you to evaluate whether the actions taken by ABC CPA Firm were actually negligent, according to the laws and regulations established in the U.S. Is it negligent to follow commonly-used judgmental procedures in determining the impact of internal control deficiencies? Is it negligent to follow reporting guidelines and only disclose internal control issues that are deemed by the auditor to be material?

This is clearly not a case of negligent misrepresentation; moreover, auditing standards require nothing more than these actions. The fact of the matter is that ABC CPA Firm made a difficult decision when evaluating whether the deficiency in the internal controls for tracking and recording inventory at Clovitech, Inc. could create material errors in the financial statements.

It is well known that auditors must rely on only a sample of transactions to determine their opinions about a company, because it would be too time consuming and expensive for companies to have auditors to look at every single transaction that occurs within a

company. The auditor collected the evidence required by audit standards, and even collected additional evidence after they found the one discrepancy to make sure that they were not missing anything. It is not the auditor's fault that they could not look at every transaction. The evidence the auditor collected clearly indicated to them at the time that there wasn't a larger issue with the account.

The fact that their opinion was wrong is irrelevant; audits cannot possibly assure that the financial statements are 100% accurate. ABC CPA Firm performed an audit that complies with auditing standards. It is clear that ABC CPA Firm is not liable for negligent misrepresentation. The plaintiff has failed to demonstrate otherwise. Accordingly, I urge you to find ABC CPA Firm not liable for negligent misrepresentation.

END OF CLOSING STATEMENTS

Please click "Next" to continue to the Judge's Instructions

Disclosure/Less Auditable Condition:

Introduction to Study

The following section provides an overview of a realistic court case that emerged following the bankruptcy of a public company. A large group of individuals who own stock in the company filed a class action suit against the auditors for negligent misrepresentation, and are seeking damages to recover losses in stock value. The circumstances of the case will be argued from the perspectives of both the plaintiff and defendant.

While reviewing the information presented to you, we ask that you evaluate the information as if you were a jury member assigned to the trial. After you review the information, you will be asked to conclude whether the independent auditor, ABC CPA Firm, is liable for negligent misrepresentation, and provide your opinions about the circumstances presented in the case.

Stockholders of Clovitech, Inc. v. ABC CPA Firm

Complaint: The plaintiffs, the stockholders of Clovitech, Inc., allege that the defendant, ABC CPA Firm, made false statements without exercising reasonable care of competence in obtaining and communicating information for the audit of the 2007 financial statements and internal controls of Clovitech, Inc. They are suing ABC CPA Firm, a large international accounting firm, for \$100 million in damages for their actual losses in stock value, and are asking for additional punitive damages to punish ABC CPA Firm for their negligent actions.

Response: The defendant, ABC CPA Firm, responds that it fully complied with auditing standards and that it was not negligent in obtaining or communicating information related to the audit of the 2007 financial statements of Clovitech, Inc.

END OF INTRODUCTION

Please click "Next" to continue to the Plaintiff Arguments

Plaintiff Arguments

This case is about auditor negligence. You are about to find out what can happen when auditors do not do their jobs properly, and stockholders lose millions of dollars as a result. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal control policies in place, which are policies within a company that are established to either prevent or detect significant inaccuracies in the financial statements (for example: restricting access to bookkeeping functions and computer systems or requiring managers to approve large transactions).

In this case, ABC CPA Firm, the auditors of Clovitech, Inc. for the past three years, discovered an issue in the internal controls established by the top level managers within the company during their audit of Clovitech Inc. for the 2007 financial statements. However, ABC CPA Firm decided that the issue wasn't important, and concluded that the internal controls within Clovitech, Inc. were effective (otherwise known as a "clean" opinion on internal controls).

Yes, they provided a disclosure of the deficiency that they discovered during their audit, but their overall "clean" opinion on internal controls was misleading. In fact, this particular internal control deficiency, a lack of sufficient internal controls established by the top level managers within the company, was the leading cause of the company's bankruptcy in 2009.

Because of ABC CPA Firm's failure to properly investigate the impact of the deficiency in internal controls, stockholders of Clovitech, Inc. lost \$100 million when the company's stock became worthless after the bankruptcy. The stockholders of Clovitech, Inc. are suing the auditor, ABC CPA Firm, for \$100 million in damages for their actual losses, and are asking for additional punitive damages to punish ABC CPA Firm for their negligent actions.

Although auditors are hired and paid by the companies whose financial statements they examine, an auditor's primary duty is to the general public. Investors and creditors often rely on the auditor's opinion on the financial statements and internal controls when deciding if they can trust the financial information released by the company, which can greatly influence their investment/lending decisions. In this case, the stockholders of Clovitech, Inc. relied on ABC CPA Firm's reports when deciding to purchase stock in the company.

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million, and reported an overall profit of \$200 million for the year. ABC CPA Firm reported that the 2007 financial statements of Clovitech, Inc. were accurate. More importantly, the auditors reported that the internal controls within the company were sufficient to assure reliance on their financial figures. Relying on this information provided by Clovitech, Inc. and ABC CPA Firm, stockholders purchased and retained stock in the company totaling \$100 million.

In February 2009, almost a year after ABC CPA Firm released these reports, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme had emerged, and it became evident that employees had been inflating sales revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock Clovitech, Inc. products by providing incentives (for example: highly favorable credit terms of 6 months or more with no interest). The sales were then recorded as income for Clovitech, Inc. The scheme was uncovered when demand for the product declined. Retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated sales revenue figures.

The discovery that this significant overstatement of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year.

The restatement was also accompanied by management's disclosure of a serious flaw in internal controls, stating that the internal controls established by the top level managers within the company were ineffective. Company policy over-emphasized meeting short term profit goals at the sacrifice of internal control at the sales division level. This weakness in internal control contributed to the fact that the employees were able to falsely inflate sales revenue figures without being detected.

On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders of Clovitech, Inc. are not arguing that ABC CPA Firm would have necessarily discovered the actual fraud if they had performed additional procedures. It is well known that managers will go to great lengths to cover up fraudulent activity. Instead, the stockholders argue that the auditors were negligent in their evaluation of internal controls within the company, and that their disclosures were misleading.

The lack of appropriate internal controls in place at Clovitech, Inc. permitted fraudulent activity to occur within the company on a continuing basis. This fraudulent activity resulted in financial statements that were not reliable, with sales revenue figures falsely inflated by over \$200 million. This overstatement in sales revenue is a serious issue, because stockholders may not have purchased stock in the company if these false sales were not included in the company's income.

Workpaper evidence indicates that ABC CPA Firm identified the deficiency in the internal controls established by the top level managers within the company that facilitated this fraudulent activity.

Although the auditor will argue that they performed additional audit procedures to confirm that the deficiency they found was not likely to cause major issues with the financial statement figures, they reported that internal controls were effective in the company. Yes, they provided a disclosure of the deficiency, but their overall conclusion on internal controls is misleading.

We argue that the type of evidence the auditor relied upon in this case to evaluate internal controls, employee interviews, was not sufficient evidence to reach their conclusions and allowed the auditor too much leeway in interpretation. Interview evidence is highly subjective, and the auditor relied heavily on professional judgment to form their opinions. How are we to know that the auditor performed their duties with care when they interpreted the interview evidence? They may have been biased against finding anything that would make more work for them or cause them to lose the client for next year's audit. Auditors are paid to provide their services to companies. How can we rely so heavily on the auditor's judgment when they are financially motivated to keep their job?

Overall, the auditor's opinion on internal controls mislead investors into thinking there were no problems with the internal controls of the company, when in fact auditors were aware of deficiencies. Even though the auditor did voluntarily disclose the fact that they discovered the deficiency, they reported a "clean" opinion on internal controls, expressing that controls within the company were "effective"

We claim that, because of their negligence and resulting misleading statement within their audit opinion on internal controls, the auditor did not signal investors of the true potential that the financial statements may not be accurate. Therefore, I am asking on behalf of the stockholders of Clovitech, Inc. that you find ABC CPA Firm liable for negligent misrepresentation. We ask that you compensate the stockholders \$100 million for the loss in stock value, and that you punish the auditors appropriately by awarding punitive damages as well.

END OF PLAINTIFF ARGUMENTS

Please click "Next" to continue to the Defendant's Arguments

Defendant Arguments

Our position is that ABC CPA Firm fully complied with auditing standards in its audit of Clovitech, Inc.'s 2007 financial statements and internal controls. We argue that ABC CPA Firm should not be liable for negligent misrepresentation. To help you understand why the auditor's actions were in fact not negligent, I would like to first give you a short background on what the auditor's responsibilities are in the financial reporting process.

Then, I will provide specific details about the 2007 audit of Clovitech, Inc.'s internal controls to show that the auditor performed well within the duty of care required by the audit standards in the U.S. In fact, the auditor went beyond their duty and voluntarily reported a deficiency in internal controls that they are in no way required to disclose to the public. After you hear these facts, you will no doubt find that ABC CPA Firm should be found not liable for negligent misrepresentation.

An auditor's job is to reduce the probability that people receive misstated financial statements, but auditors cannot provide 100% assurance that financial statements are accurate. Auditors could potentially find every misstatement, but to do so they would have to examine every single transaction in which a company took part. This would make the cost of an audit so high that no one would be able to afford an audit at all. Instead, auditors examine a subset of transactions by using their professional judgment and sophisticated sampling techniques. This is what auditing standards require.

The auditor also conducts an evaluation of internal controls to determine if the company has controls in place to prevent the employees from committing fraud and/or making errors. Since the auditor cannot possibly look at every transaction, high quality internal controls are important because they provide additional assurance that a company's financial statements are accurate. During this process, the auditor frequently identifies deficiencies in internal controls, particularly with a company this size, which could have an excellent system of internal controls but still end up with hundreds of small ways that fraud could be committed.

Most of the time, these deficiencies are deemed to be immaterial, in the sense that they will not likely lead to large discrepancies in the financial statement figures. These deficiencies are privately disclosed to the company so that they can improve internal controls, and many times the company is able to resolve the issue before it becomes a problem. However, unless the auditor believes that an unresolved deficiency could lead to a large error in the financial statements, audit standards do not require that auditors modify their opinions about the company's financial statements and internal controls, and they are not required to disclose anything about the deficiencies to the public.

The plaintiff is arguing that if the auditor had performed procedures correctly, they would have known that there was an increased risk of error and fraud in the company, and would have modified their opinion accordingly. Unfortunately, the decisions made by auditors are not always black and white. It is well known in the professional community that the audit of internal controls is a difficult process that requires auditors to rely heavily on their professional

judgment and instincts in certain situations. At times, there isn't solid evidence that the auditor can collect to support their judgments.

In this particular situation, during their audit of the 2007 financial statements and internal controls of Clovitech, Inc., ABC CPA Firm discovered and documented **334 internal control deficiencies** in various areas in the company, an average amount for a company of this size. All of these deficiencies were either corrected by Clovitech, Inc. or the auditor decided that the deficiency was not likely to expose the company to large errors in the financial statements.

One of these **334** deficiencies was in the **internal controls established by top level management**. This deficiency was identified when the auditor **performed interviews** with a sample of sales representatives from three different offices to gain an understanding of the general attitude of upper level management. Only **one** sales representative, of the employees interviewed, indicated that **management was overly focused on meeting sales projections**, and **would not care if the revenue figures were inflated** as long as the projections were met.

ABC CPA Firm immediately identified this as a significant deficiency in internal controls and documented the findings in their workpapers. To see whether the deficiency could be a larger issue, the auditor expanded their sample to interview an **additional sample of employees** and found **no other indication** that the employees felt pressured to inflate their revenue figures. In their routine procedures to test for the accuracy of revenue figures, the auditor **also** examined a sample of **sales transactions**, and found them all to be **legitimate sales**.

Based on this evidence, ABC CPA Firm decided that this **deficiency in the internal controls established by top management** would **not** be likely to cause a **material misstatement** of the **financial statements**. The auditor relied on this evidence and their own professional judgment in this case to formulate their opinions about the deficiency.

Although the plaintiff argues that the auditor did not perform enough procedures to properly assess the impact of this internal control issue, we argue that the auditor operated within audit standards and documented their findings accordingly. They concluded, based on the evidence at the time, that there was **not** a **material weakness** in **internal controls**. This means that they do not believe that the deficiency would be bad enough to potentially lead to a significant error in the financial statement figures.

Based on this conclusion and audit standards, the auditor had **no responsibility to disclose any information** on the internal control deficiency at all, as auditors are **not required by audit standards to disclose internal control deficiencies if they are not deemed material weaknesses**. However, the auditor **went above and beyond** the call of duty and **voluntarily disclosed** that they found a **deficiency in internal controls**. This voluntary disclosure was **entirely optional**, and auditors decided to make the disclosure to communicate to investors that there may be an issue in internal controls, even though the auditor did not find any errors in the financial statements.

To put this into perspective, this was **the only** deficiency, **out of 334**, where the auditor's judgment turned out to be inaccurate in hindsight. If we think in broader terms about how many

deficiencies an audit firm will identify each year across all of their clients in the U.S., this is **one deficiency out of thousands**. No person should ever be held to such a standard of perfection, especially when they clearly performed their job within the standard guidelines of the profession.

Negligent misrepresentation 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. The auditor being sued in this case **clearly performed the appropriate audit procedures to evaluate internal controls**. The **additional voluntary disclosure** related to **internal controls** provided by the auditor went **above and beyond the call of duty**, as the auditor was **not required to say anything at all** about the deficiency within the report. It is the defense's position that if an auditor complies with auditing standards, he has not been negligent. Has the plaintiff proven that this is a case of negligent misrepresentation on the part of the auditor? Absolutely not.

END OF DEFENDANT ARGUMENTS

Please click "Next" to continue to the Closing Statements

Closing Statements

Plaintiff Closing Statement

Society expects more than this from auditors. We expect auditors to maintain an attitude of professional skepticism in dealing with their clients. We expect auditors to take any irregularities in their clients' internal control procedures seriously, as such measures are in place to prevent fraudulent activities such as the ones that led to material misstatements in Clovitech, Inc.'s financial statements.

The auditor admits that an employee of Clovitech raised a concern about **the internal controls established by top management**, but the auditor dismissed the individual on the basis that other employees didn't feel the same way. Did they stop to think that the people they are interviewing are likely to be the exact people perpetrating fraud? Of course, the auditor **relied on professional judgment** to make their decision, but how are we to know whether they made this judgment responsibly and not out of their own self interest?

Auditors are being paid to perform their services, and have been known to downplay issues they find so that they are hired again for the next year. In conclusion, ABC CPA Firm clearly did not live up to society's expectations, and should be held accountable for their actions. Because of the auditor's negligent actions, the **stockholders lost \$100 million** through their investment. Therefore, I urge you to find ABC CPA Firm liable for negligent misrepresentation. I also urge

you to require the auditors to compensate these stockholders for their losses, and punish the auditors for not doing their job.

Defendant Closing Statement

The plaintiff has told you that ABC CPA Firm made some mistakes in its audit of the 2007 financial statements of Clovitech, Inc., specifically in their evaluation of internal controls. It is now up to you to evaluate whether the actions taken by ABC CPA Firm were actually negligent, according to the laws and regulations established in the U.S. Is it negligent to **follow commonly-used judgmental procedures** in determining the impact of internal control deficiencies? Is it negligent to go **above and beyond reporting guidelines** and **disclose internal control issues** that are deemed by the auditor to be important?

This is clearly **not** a case of **negligent misrepresentation**; moreover, auditing standards require nothing more than these actions. The fact of the matter is that ABC CPA Firm made a difficult decision when evaluating whether the deficiency in the **internal controls established by top management** at Clovitech, Inc. could create **material errors in the financial statements**.

It is well known in practice that this particular control deficiency is very difficult to evaluate because it **requires the auditor to rely on their perceptions** about a situation **based on interviews**. If the auditor had the ability to collect additional evidence in this case that would allow them to rely less on individual perceptions, they certainly would have done so. However, this is not the case, because **evaluating the internal controls established by top management is very subjective**, and the auditor was forced to make a decision **based on their professional judgment** about the situation. It is not the auditor's fault that they could not collect other types of evidence that would rely less on their professional judgment. The evidence that the auditor collected clearly indicated to them at the time that there wasn't a larger issue with the account.

The fact that their opinion was wrong is irrelevant; audits cannot possibly assure that the financial statements are 100% accurate. ABC CPA Firm performed an audit that **complies with, and even surpasses, auditing standards**. The auditor even **voluntarily provided a disclosure of the internal control deficiency** in their report, which is **not required by standards**. It is clear that ABC CPA Firm is not liable for negligent misrepresentation. The plaintiff has failed to demonstrate otherwise. Accordingly, I urge you to find ABC CPA Firm **not liable** for **negligent misrepresentation**.

END OF CLOSING STATEMENTS

Please click "Next" to continue to the Judge's Instructions

Disclosure/More Auditable Condition:

Introduction to Study

The following section provides an overview of a realistic court case that emerged following the bankruptcy of a public company. A large group of individuals who own stock in the company filed a class action suit against the auditors for negligent misrepresentation, and are seeking damages to recover losses in stock value. The circumstances of the case will be argued from the perspectives of both the plaintiff and defendant.

While reviewing the information presented to you, we ask that you evaluate the information as if you were a jury member assigned to the trial. After you review the information, you will be asked to conclude whether the independent auditor, ABC CPA Firm, is liable for negligent misrepresentation, and provide your opinions about the circumstances presented in the case.

Stockholders of Clovitech, Inc. v. ABC CPA Firm

Complaint: The plaintiffs, the stockholders of Clovitech, Inc., allege that the defendant, ABC CPA Firm, made false statements without exercising reasonable care of competence in obtaining and communicating information for the audit of the 2007 financial statements and internal controls of Clovitech, Inc. They are suing ABC CPA Firm, a large international accounting firm, for \$100 million in damages for their actual losses in stock value, and are asking for additional punitive damages to punish ABC CPA Firm for their negligent actions.

Response: The defendant, ABC CPA Firm, responds that it fully complied with auditing standards and that it was not negligent in obtaining or communicating information related to the audit of the 2007 financial statements of Clovitech, Inc.

END OF INTRODUCTION

Please click "Next" to continue to the Plaintiff Arguments

Plaintiff Arguments

This case is about auditor negligence. You are about to find out what can happen when auditors do not do their jobs properly, and stockholders lose millions of dollars as a result. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal

control policies in place, which are policies within a company that are established to either prevent or detect significant inaccuracies in the financial statements (for example: restricting access to bookkeeping functions and computer systems or requiring managers to approve large transactions).

In this case, ABC CPA Firm, the auditors of Clovitech, Inc. for the past three years, discovered an issue in the internal controls for tracking and reporting inventory during their audit of Clovitech Inc. for the 2007 financial statements. However, ABC CPA Firm decided that the issue wasn't important, and concluded that the internal controls within Clovitech, Inc. were effective (otherwise known as a "clean" opinion on internal controls).

Yes, they provided a disclosure of the deficiency that they discovered during their audit, but their overall "clean" opinion on internal controls was misleading. In fact, this particular internal control deficiency, a lack of sufficient internal controls for tracking and reporting inventory, was the leading cause of the company's bankruptcy in 2009.

Because of ABC CPA Firm's failure to properly investigate the impact of the deficiency in internal controls, stockholders of Clovitech, Inc. lost \$100 million when the company's stock became worthless after the bankruptcy. The stockholders of Clovitech, Inc. are suing the auditor, ABC CPA Firm, for \$100 million in damages for their actual losses, and are asking for additional punitive damages to punish ABC CPA Firm for their negligent actions.

Although auditors are hired and paid by the companies whose financial statements they examine, an auditor's primary duty is to the general public. Investors and creditors often rely on the auditor's opinion on the financial statements and internal controls when deciding if they can trust the financial information released by the company, which can greatly influence their investment/lending decisions. In this case, the stockholders of Clovitech, Inc. relied on ABC CPA Firm's reports when deciding to purchase stock in the company.

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million, and reported an overall profit of \$200 million for the year. ABC CPA Firm reported that the 2007 financial statements of Clovitech, Inc. were accurate. More importantly, the auditors reported that the internal controls within the company were sufficient to assure reliance on their financial figures. Relying on this information provided by Clovitech, Inc. and ABC CPA Firm, stockholders purchased and retained stock in the company totaling \$100 million.

In February 2009, almost a year after ABC CPA Firm released these reports, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme had emerged, and it became evident that employees had been inflating sales revenues to meet projections and conceal significant declines in demand for their products

for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock Clovitech, Inc. products by providing incentives (for example: highly favorable credit terms of 6 months or more with no interest). The sales were then recorded as income for Clovitech, Inc. The scheme was uncovered when **demand for the product declined**. Retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on **intentionally manipulated sales revenue figures**.

The discovery that this significant overstatement of sales revenue figures had been occurring since the beginning of 2007 prompted the company to **decrease** their 2007 reported **sales revenues** by **over \$200 million**, resulting in an **overall loss of \$10 million for the year**.

The restatement was also accompanied by management's disclosure of a serious flaw in internal controls, stating that the **internal controls for tracking and reporting inventory** are ineffective and resulted in unreliable monitoring of inventory counts and demands. **This weakness in internal control contributed to the fact that the employees were able to falsely inflate sales revenue figures without being detected**.

On the day the **restatement** was announced, Clovitech, Inc. stock **dropped 50%** in value from **\$28 to \$14** per share. Only one week later, following the **bankruptcy** announcement, the stock was considered **worthless**, with total losses for this group of shareholders estimated at **\$100 million**.

The stockholders of Clovitech, Inc. are **not** arguing that ABC CPA Firm would have necessarily discovered the **actual fraud** if they had performed additional procedures. It is well known that managers will go to great lengths to cover up fraudulent activity. Instead, the stockholders argue that the auditors were negligent in their **evaluation of internal controls** within the company, and that their **disclosures were misleading**.

The **lack of appropriate internal controls** in place at Clovitech, Inc. **permitted fraudulent activity to occur** within the company on a continuing basis. This fraudulent activity resulted in financial statements that were not reliable, with **sales revenue** figures falsely inflated by over **\$200 million**. This overstatement in sales revenue is a serious issue, because stockholders may not have purchased stock in the company if these false sales were not included in the company's income.

Workpaper evidence indicates that ABC CPA Firm identified the deficiency in the **internal controls for tracking and reporting inventory** that **facilitated this fraudulent activity**.

Although the auditor will argue that they performed additional audit procedures to confirm

that the deficiency they found was not likely to cause major issues with the financial statement figures, they reported that **internal controls** were **effective** in the company. Yes, they **provided a disclosure** of the deficiency, but their overall conclusion on internal controls is **misleading**.

We argue that the **type of evidence** the auditor relied upon in this case to evaluate internal controls, **statistical sampling of transactions**, was **not sufficient** evidence to reach their conclusions. This evidence only **represents a small subset** of all of the transactions in the company. How are we to know that the auditor performed their duties with care when they examined the evidence they collected? They may have been biased against finding anything that would make more work for them or cause them to lose the client for next year's audit. Auditors are paid to provide their services to companies. How can we rely so heavily on the auditor's judgment when they are financially motivated to keep their job?

Overall, the **auditor's opinion on internal controls mislead investors** into thinking there were no problems with the internal controls of the company, when in fact auditors were aware of deficiencies. Even though the auditor **did voluntarily disclose** the fact that they discovered the deficiency, they reported a "clean" opinion on internal controls, expressing that **controls within the company were "effective"**

We claim that, because of their **negligence** and resulting **misleading statement** within their **audit opinion on internal controls**, the auditor **did not signal investors** of the true potential that the financial statements may not be accurate. Therefore, I am asking on behalf of the stockholders of Clovitech, Inc. that you find ABC CPA Firm liable for **negligent misrepresentation**. We ask that you compensate the stockholders **\$100 million** for the loss in stock value, and that you punish the auditors appropriately by awarding **punitive damages** as well.

END OF PLAINTIFF ARGUMENTS

Please click "Next" to continue to the Defendant's Arguments

Defendant Arguments

Our position is that ABC CPA Firm **fully complied with auditing standards** in its audit of Clovitech, Inc.'s 2007 financial statements and internal controls. We argue that ABC CPA Firm **should not be liable for negligent misrepresentation**. To help you understand why the auditor's actions were in fact **not negligent**, I would like to first give you a short background on what the auditor's responsibilities are in the financial reporting process.

Then, I will provide specific details about the 2007 audit of Clovitech, Inc.'s **internal controls** to show that the auditor performed **well within the duty of care** required by the **audit standards** in the U.S. In fact, the auditor **went beyond their duty** and **voluntarily reported a deficiency in internal controls** that they are in **no way required to disclose to the public**. After you hear these facts, you will no doubt find that ABC CPA Firm should be found **not liable** for **negligent misrepresentation**.

An auditor's job is to reduce the probability that people receive misstated financial statements, but **auditors cannot provide 100% assurance that financial statements are accurate**. Auditors could potentially find every misstatement, but to do so they would have to examine every single transaction in which a company took part. This would make the cost of an audit so high that no one would be able to afford an audit at all. Instead, auditors examine a subset of transactions by using their professional judgment and sophisticated sampling techniques. This is what auditing standards require.

The auditor also conducts an **evaluation of internal controls** to determine if the company has controls in place to prevent the employees from committing fraud and/or making errors. Since the auditor cannot possibly look at every transaction, high quality internal controls are important because **they provide additional assurance that a company's financial statements are accurate**. During this process, the auditor frequently identifies deficiencies in internal controls, particularly with a company this size, which could have an excellent system of internal controls but still end up with hundreds of small ways that fraud could be committed.

Most of the time, these deficiencies are deemed to be immaterial, in the sense that they will not likely lead to large discrepancies in the financial statement figures. These deficiencies are privately disclosed to the company so that they can improve internal controls, and many times the company is able to resolve the issue before it becomes a problem. However, **unless the auditor believes that an unresolved deficiency could lead to a large error in the financial statements, audit standards do not require that auditors modify their opinions about the company's financial statements and internal controls, and they are not required to disclose anything about the deficiencies to the public.**

The plaintiff is arguing that if the auditor had performed procedures correctly, they would have known that there was an increased risk of error and fraud in the company, and would have modified their opinion accordingly. Unfortunately, the decisions made by auditors are not always black and white. It is well known in the professional community that the **audit of internal controls is a difficult process** that requires auditors to rely heavily on their professional judgment and instincts in certain situations. At times, there isn't solid evidence that the auditor can collect to support their judgments.

In this particular situation, during their audit of the 2007 financial statements and internal controls of Clovitech, Inc., ABC CPA Firm discovered and documented **334 internal control deficiencies** in various areas in the company, an average amount for a company of

this size. All of these deficiencies were either corrected by Clovitech, Inc. or the auditor decided that the deficiency was not likely to expose the company to large errors in the financial statements.

One of these 334 deficiencies was in the internal controls for tracking and recording inventory. This deficiency was identified when the auditor examined inventory records at three different offices to make sure that employees were tracking and recording inventory properly. Only one record, out of the records examined, indicated that inventory counts and records may not be consistently updated and errors may not be resolved.

ABC CPA Firm immediately identified this as a significant deficiency in internal controls and documented the findings in their workpapers. To see whether the deficiency could be a larger issue, the auditor expanded their sample to examine an additional sample of records and found no other indication that the inventory count and record keeping procedures were deficient. In their routine procedures to test for the accuracy of revenue figures, the auditor also examined a sample of sales transactions, and found them all to be legitimate sales.

Based on this evidence, ABC CPA Firm decided that this deficiency in the internal controls over inventory procedures would not be likely to cause a material misstatement of the financial statements. The auditor relied on this evidence to formulate their opinions about the deficiency.

Although the plaintiff argues that the auditor did not perform enough procedures to properly assess the impact of this internal control issue, we argue that the auditor operated within audit standards and documented their findings accordingly. They concluded, based on the evidence at the time, that there was not a material weakness in internal controls. This means that they do not believe that the deficiency would be bad enough to potentially lead to a significant error in the financial statement figures.

Based on this conclusion and audit standards, the auditor had no responsibility to disclose any information on the internal control deficiency at all, as auditors are not required by audit standards to disclose internal control deficiencies if they are not deemed material weaknesses. However, the auditor went above and beyond the call of duty and voluntarily disclosed that they found a deficiency in internal controls. This voluntary disclosure was entirely optional, and auditors decided to make the disclosure to communicate to investors that there may be an issue in internal controls, even though the auditor did not find any errors in the financial statements.

To put this into perspective, this was the only deficiency, out of 334, where the auditor's judgment turned out to be inaccurate in hindsight. If we think in broader terms about how many deficiencies an audit firm will identify each year across all of their clients in the U.S., this is one deficiency out of thousands. No person should ever be held to such a standard of perfection, especially when they clearly performed their job within the standard guidelines

of the profession.

Negligent misrepresentation 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. The auditor being sued in this case clearly performed the appropriate audit procedures to evaluate internal controls. The additional voluntary disclosure related to internal controls provided by the auditor went above and beyond the call of duty, as the auditor was not required to say anything at all about the deficiency within the report. It is the defense's position that if an auditor complies with auditing standards, he has not been negligent. Has the plaintiff proven that this is a case of negligent misrepresentation on the part of the auditor? Absolutely not.

END OF DEFENDANT ARGUMENTS

Please click "Next" to continue to the Closing Statements

Closing Statements

Plaintiff Closing Statement

Society expects more than this from auditors. We expect auditors to maintain an attitude of professional skepticism in dealing with their clients. We expect auditors to take any irregularities in their clients' internal control procedures seriously, as such measures are in place to prevent fraudulent activities such as the ones that led to material misstatements in Clovitech, Inc.'s financial statements.

The auditor admits that they found evidence of a discrepancy in the inventory records, but the auditor dismissed it on the basis that they didn't find any other discrepancies. Did they stop to think that there may be many more discrepancies in the account that they didn't even look at? Of course, the auditor relied on statistics to evaluate the potential for bigger issues in the company, but how are we to know they made this judgment responsibly and not out of their own self interest?

Auditors are being paid to perform their services, and have been known to downplay issues they find so that they are hired again for the next year. In conclusion, ABC CPA Firm clearly did not live up to society's expectations, and should be held accountable for their actions. Because of the auditor's negligent actions, the stockholders lost \$100 million through their investment. Therefore, I urge you to find ABC CPA Firm liable for negligent misrepresentation. I also urge you to require the auditors to compensate these stockholders for their losses, and punish the auditors for not doing their job.

Defendant Closing Statement

The plaintiff has told you that ABC CPA Firm made some mistakes in its audit of the 2007 financial statements of Clovitech, Inc., specifically in their evaluation of internal controls. It is now up to you to evaluate whether the actions taken by ABC CPA Firm were actually negligent, according to the laws and regulations established in the U.S. Is it negligent to **follow commonly-used judgmental procedures** in determining the impact of internal control deficiencies? Is it negligent to go **above and beyond reporting guidelines** and **disclose internal control issues** that are deemed by the auditor to be important?

This is clearly **not** a case of **negligent misrepresentation**; moreover, auditing standards require nothing more than these actions. The fact of the matter is that ABC CPA Firm made a difficult decision when evaluating whether the deficiency in the **internal controls for tracking and recording inventory** at Clovitech, Inc. could create **material errors in the financial statements**.

It is well known that auditors must rely on only a **sample of transactions** to determine their opinions about a company, because it would be **too time consuming** and **expensive** for companies to have auditors to look at **every single transaction** that occurs within a company. The auditor collected the evidence **required by audit standards**, and **even collected additional evidence** after they found the one discrepancy to make sure that they were not missing anything. It is not the auditor's fault that they could not look at every transaction. The evidence the auditor collected clearly indicated to them at the time that there wasn't a larger issue with the account.

The fact that their opinion was wrong is irrelevant; audits cannot possibly assure that the financial statements are 100% accurate. ABC CPA Firm performed an audit that **complies with, and even surpasses, auditing standards**. The auditor even **voluntarily provided a disclosure of the internal control deficiency** in their report, which is **not required by standards**. It is clear that ABC CPA Firm is not liable for negligent misrepresentation. The plaintiff has failed to demonstrate otherwise. Accordingly, I urge you to find ABC CPA Firm **not liable** for **negligent misrepresentation**.

END OF CLOSING STATEMENTS

Please click "Next" to continue to the Judge's Instructions

Note: the following section was the same for all four cases:

Judge's Instructions

As jury members, you are now responsible for evaluating the case presented to you, keeping in mind the following instructions related to the laws governing claims of negligent misrepresentation. The burden of proof in this case lies with the plaintiff.

In order to be successful on a claim of negligent misrepresentation, the plaintiff must prove that ABC CPA Firm made false statements without exercising reasonable care of competence in obtaining OR communicating information for the audit of the 2007 financial statements and internal controls of Clovitech, Inc. You should consider whether the defendant complied with professional auditing standards in making your evaluation.

If you decide that ABC CPA Firm did exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community in both obtaining AND communicating information, you must find them NOT LIABLE for negligent misrepresentation.

If you decide that ABC CPA Firm did not exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community in either obtaining OR communicating information, you must find them LIABLE for negligent misrepresentation.

You have now concluded the audio/video portion of this task.

Please Click "Next" to continue to the next screen.

Please answer the following questions as if you were a jury member in the trial for the lawsuit filed by the stockholders of Clovitech, Inc. against the auditors, ABC CPA Firm. Please note, these questions are asked to gain your opinion on the case you reviewed in the previous section, so there is no “right” or “wrong” answer to these questions.

In this case, stockholders are suing the defendant, ABC CPA Firm, for negligent misrepresentation. A defendant may be found liable for negligent misrepresentation when the defendant makes false statements without exercising reasonable care of competence in obtaining or communicating the information.

How would you vote?

- The auditor is liable for negligent misrepresentation.
- The auditor is NOT liable for negligent misrepresentation.

The stockholders in this case are suing for \$100 million in compensatory damages and undetermined punitive damages. When answering the following questions, please note the provided definitions:

Compensatory damages: Amount of money adequate to compensate for any *actual damages* caused by the party against whom they awarded. In this case, stockholders are suing for compensation of \$100 million in actual losses.

As one of the jurors, what dollar amount in *compensatory damages* would you recommend be awarded to the stockholders? You must decide on a dollar amount from \$0 to \$100,000,000.

Please enter a whole number (no decimals) with no dollar signs or commas. _____

Punitive Damages: Amount of money awarded to *punish* a defendant and to deter a defendant and others from committing similar acts in the future. Punitive damages are usually awarded in cases where the defendant's actions were very offensive. Punitive damages are awarded *in addition* to the compensatory damages, so your answer to the previous question on compensatory damages does not impact your decision for punitive damages. In this case, assume that the punitive damages are limited to \$200 million.

As one of the jurors, what dollar amount in *punitive damages* would you recommend be awarded to the stockholders? You must decide on a dollar amount from \$0 to \$200,000,000.

Please enter a whole number (no decimals) with no dollar signs or commas. _____

The following questions are asked to gain your perspectives about the actions of ABC CPA Firm (the auditor of Clovitech, Inc.) based on what you read in the scenario presented to you.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
ABC CPA Firm is liable for negligent misrepresentation.	0	0	0	0	0	0	0
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed.	0	0	0	0	0	0	0
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose.	0	0	0	0	0	0	0
ABC CPA Firm could have prevented the stockholder losses.	0	0	0	0	0	0	0
ABC CPA Firm is responsible for stockholder losses.	0	0	0	0	0	0	0

Please answer the remaining questions in this survey without looking back at the case:

What did the auditors, ABC CPA Firm, conclude in their report on internal controls for the 2007 financial statements for Clovitech, Inc.?

- The independent auditors reported a **“clean”** opinion on internal controls, with **no disclosure** of any significant deficiencies in internal controls.
- The independent auditors reported a **“clean”** opinion on internal controls, but **voluntarily disclosed** a significant deficiency in internal controls.

What factor was specifically mentioned in the case as the largest contributing factor in the lack of detection or prevention of fraud for Clovitech, and was cited as a major component in the plaintiff's case against the auditor, ABC CPA Firm?

- Ineffective internal controls for **tracking and recording inventory**; records were not updated and often inaccurate.
- Ineffective internal controls **established by top management**; employees were overly encouraged to meet short term goals instead of assuring long term success of the company.

In your opinion, how much did the auditor, ABC CPA Firm, have to rely on their professional judgment (instead of hard evidence) when making their decisions concerning the 2007 audit of Clovitech, Inc.?

Relied Completely on Judgment	Relied Somewhat on Judgment	Relied Slightly on Judgment	Relied Equally on Judgment and Evidence	Relied Slightly on Evidence	Relied Somewhat on Evidence	Relied Completely on Evidence
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The following questions are asked to gain your perspectives about this task

Please select "Yes" or "No" depending on your experience with the task you completed.

Did you listen to the audio recording provided for this task? Yes No

Did you read the text provided for this task? Yes No

Did you click to open the PDF file and read the auditor's report on internal controls? Yes No

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The task was difficult.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The task was enjoyable.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
The task was realistic.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Did you experience any technical difficulties with the technology for this task? Yes No

If yes, please describe:

The following questions are asked to allow the researchers to further understand the demographics of the individuals responding to this study. The answers are entirely voluntary, but are very important to the research.

What is your age?

What is your gender?

Are you currently a U. S. Citizen?

What is your current state of residence?

Are you currently registered to vote in the US?

Are you currently registered to vote in the US?

If you are currently registered to vote within the U.S., with which political party are you affiliated?

- Republican
- Democrat
- Independent
- Other

If other, please specify

Have you ever been called for jury duty in the U.S?

Have you ever served on a jury in the U.S.?

- No
- Yes, for a civil trial
- Yes, for a criminal trial

Are you currently or have you ever been:

A Certified Public Accountant?

An Auditor?

A Manager in a business where a financial audit was conducted?

A Professional Investor (provided investment advice or made investments for others as your main source of employment)?

An attorney?

A member of an audit committee?

Are you currently a student?

What is the highest level of education you have attained?

- | | |
|--|---|
| <input type="radio"/> Some High School | <input type="radio"/> Graduated College |
| <input type="radio"/> Completed High School (or Equivalent) | <input type="radio"/> Some Post-Graduate School |
| <input type="radio"/> Completed Trade or Professional School | <input type="radio"/> Completed Graduate School |
| <input type="radio"/> Some College | |

What is your approximate annual gross family income?

- | | | |
|---|---|---|
| <input type="radio"/> less than \$10,000 | <input type="radio"/> \$40,000 - \$54,999 | <input type="radio"/> \$85,000 - \$ 99,999 |
| <input type="radio"/> \$10,000 - \$24,999 | <input type="radio"/> \$55,000 - \$69,999 | <input type="radio"/> \$100,000 - \$199,999 |
| <input type="radio"/> \$25,000 - \$39,999 | <input type="radio"/> \$70,000 - \$84,999 | <input type="radio"/> \$200,000 or more |

Which of the following describes your current employment status? Please select ALL that apply.

- | | |
|---|--|
| <input type="checkbox"/> Employed full-time | <input type="checkbox"/> Retired |
| <input type="checkbox"/> Employed part-time | <input type="checkbox"/> Stay-at-home parent or homemaker |
| <input type="checkbox"/> Self-employed | <input type="checkbox"/> Unemployed (and looking for employment) |
| <input type="checkbox"/> Full-time student | <input type="checkbox"/> Other |

If other, please specify

If you are currently employed or self-employed, what is your field of employment (for example, education, health care, manufacturing, etc.)?

What is your race/ethnicity?

- American Indian or Alaskan Native
- Asian or Pacific Islander
- Black
- White
- Hispanic
- Other

If other, please specify

The following questions are commonly asked in the jury selection process for court cases. Please answer either “yes” or “no” to each of the following questions:

Have you or a family member or close personal friend either currently or in the past been involved as a party (either a plaintiff or a defendant) in a lawsuit involving damages for professional negligence (medical malpractice, accounting malpractice, etc.)?

Have you or a family member or close personal friend either currently or in the past been involved as a party (either a plaintiff or a defendant) in a class action lawsuit?

A plaintiff is a person or corporation who has initiated a lawsuit. Would you have a bias for or against a plaintiff simply because he or she has brought a lawsuit?

A defendant is a person or corporation against whom a lawsuit has been brought. Would you have a bias for or against a defendant simply because a lawsuit has been brought against him or her?

If the law and evidence warranted, would you be able to render a verdict for defendant regardless of any sympathy you may have for either party?

Would your verdict in this case be influenced in any way by any factors other than the evidence in the courtroom such as friendships or family relationships or the type of work you do?

Have you ever testified in any court proceeding?

Have you ever been a witness in a civil matter, regardless of whether it went to trial?

Do you, or have you ever, owned stock in a company?

Have you ever owned stock in a company that has declared bankruptcy?

If you were called for jury duty, would you try to avoid having to serve on the jury?

APPENDIX D: STUDY 3 CASES AND QUESTIONNAIRE

Cases (presented separately by condition)

Study Instructions

The following section provides details related to the bankruptcy of a public company, and a lawsuit filed by stockholders against the company's auditor. While reviewing the information presented to you, we ask that you evaluate the information as if you were a *jury member* assigned to the trial. After you review the information, you will be asked to conclude whether the *auditor* is *liable for negligent misrepresentation*, and provide your opinions about the circumstances presented in the case.

(Low Independence/Low Expertise Case)

I. Background on Clovitech, Inc.:

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million and an overall profit of \$200 million, with positive indications for future growth. The stock for the company immediately following the release of the 2007 report was on a consistent positive trend, and analysts considered the company a solid investment.

Clovitech, Inc. has been audited by ABC CPA Firm, a large international accounting firm, for the past three years. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal control policies in place, which are procedures that are designed to prevent or detect significant inaccuracies in the financial statements. Auditors must issue an opinion on the adequacy of the internal controls and issue an opinion on whether the financial statements are fairly presented. For 2007, ABC CPA Firm issued an opinion stating that the 2007 financial statements of Clovitech, Inc. were reliable. They also expressed an opinion stating that the internal controls within the company were sufficient to assure reliance on their financial figures.

In their 2007 annual report Clovitech, Inc. reported details on their audit committee. Audit committees are required for all public companies, and serve multiple purposes. The audit committee selects the independent audit firm, and is in charge of paying the auditor. The Committee also reviews the procedures of the independent registered audit firm for ensuring the auditor's independence with respect to the services performed for the Company. Therefore, the members of the audit committee have an important job in assuring that the external auditors are performing up to standards and making independent and objective decisions.

While audit committee members are members of the Board of Directors, only a subset of the full Board are on the audit committee. The members of the audit committee are usually members of the business community that are not currently working directly for the company in any other way. Members are permitted to own stock in the company; although it is encouraged they own less than 10% of the company stock to maintain a distant relationship with the company. Any

stock ownership in the company might influence the ability for the audit committee member to make objective decisions during the auditing and reporting process.

To remain in compliance with laws, the company must also disclose whether members of the audit committee would be considered experts in finance or accounting. This expertise is considered important because of the high level of influence the audit committee has on the oversight of auditing and financial reporting in the company. However, companies are not actually required to have an expert audit committee member. They are only required to provide a disclosure about the members' level of expertise. If none of the members could be considered experts in finance or auditing, the company must disclose why they feel the members are appropriate for the job.

In 2007, Clovitech, Inc. publicly reported that the audit committee operated in compliance with the suggested requirements for public companies by assuring that all members did not have significant financial investments or professional relationships with the company. The company also disclosed details on the level of expertise of the audit committee members.

In their report, Clovitech stated that the audit committee consisted of 3 members who own an average of 8% of stock in the company. Although no single member of the audit committee qualifies as an expert in finance or accounting, Clovitech reported that the collective knowledge of the audit committee covers the necessary knowledge needed to fulfill their roles.

An independent organization that collects information about public companies and their audit committees performed a detailed analysis of Clovitech's audit committee in 2007. Their analysis generates a score out of 100 based on key factors that are common characteristics of high quality audit committees. The level of expertise for the audit committee of Clovitech, Inc. was rated "low" with a score of 30/100. The committee's level of freedom from financial or professional relationships with the company was also rated "low" with a score of 30/100, meaning that the committee members have a close relationship to the company.

Summary of Clovitech, Inc. audit committee characteristics, as described above:

Clovitech, Inc. Audit Committee Characteristics		Independent Audit Committee Quality Rating of Clovitech, Inc. Audit Committee
Average Amount of Clovitech, Inc. Stock Owned by Audit Committee Members	8%	Level of freedom from financial or professional relationships with the company rated "Low" (Score 30/100)*
Number of Audit Committee Members with Expertise in Accounting and/or Finance	None	Level of expertise rated "Low" (Score 30/100)

*Note: A Low rating in this category indicates that the committee members have a close relationship to the company.

II. Relationships between the Audit Committee, Top Management, and the Auditor

Audit committees are in charge of overseeing the audit process, and are often consulted when a disagreement occurs between managers of the company and the external auditor in examining the company's records and internal controls. The relationship between these three groups is important to understand, as the quality of the audit can often depend on the qualifications and objectivity of each of the groups. One of the main ways that companies maintain an independent audit is making sure that the external auditor is not overly subjected to pressure to comply with management's requests, so that the decisions made about the audit are in the best interests of shareholders and creditors.

Since managers of the company are often compensated directly based on their performance, and are financially motivated to show profits and meet projections, they are often deemed to have the least amount of objectivity when evaluating financial reporting issues.

Audit committees are paid by the company, but are required to keep a minimum level of investment in the company to increase objectivity.

Auditors are paid by the audit committee, which provides an additional level of distance between the auditor and management, which is intended to increase the auditor's objectivity when making decisions about the company's financial statements.

III. Clovitech, Inc. Declares Bankruptcy

On February 20th 2009, almost a year after the 2007 financial statements of Clovitech, Inc. were released, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme emerged, and it became evident that employees had been consistently inflating revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock the products with incentives (i.e. highly favorable credit terms of 6 months or more with no interest). The scheme was uncovered when significant decreases in demand for the product caught up with the company, as retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated revenue figures. Multiple employees admitted their participation in the scheme to inflate sales revenues.

The discovery that this manipulation of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year. The restatement was also accompanied by management's disclosure of a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Management had over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level, and did not establish proper controls in place to assure that employees did not exaggerate sales at the division level. This weakness contributed to the fact that this fraud was able to occur without being detected, and that the financial statement figures of Clovitech, Inc. were substantially overstated.

ABC CPA Firm had discovered this particular deficiency in the internal controls established by top management during their audit of internal controls for the 2007 financial statements, and reported it to the audit committee. The auditor was particularly concerned that there may be excess pressure placed on employees to overstate revenues, and that the financial statements could be misleading as a result. The issue was brought up in an audit committee meeting, with the auditors and Clovitech executives present, to determine whether the deficiency in internal controls warranted further investigation and should be disclosed in the audit report.

In this audit committee meeting, the Clovitech executives argued that there was no evidence to suggest that any errors existed in the financial statements, and presented evidence of a formal written policy that clearly instructs employees to record income only when it is appropriate. The audit committee sided with the Clovitech executives, arguing that the existence of the policy indicates that internal controls are appropriately in place to prevent manipulation of revenue figures. Without specific evidence to argue otherwise, the auditor agreed and did not disclose any issues with internal controls over revenue recognition in their audit reports for 2007.

IV. Stockholders Sue ABC CPA Firm for Negligent Misrepresentation

Stockholders of Clovitech, Inc. consulted a lawyer and decided to sue the auditor, ABC CPA Firm, as a group in a class action lawsuit, alleging that the auditors negligently supplied false information to stockholders. The stockholders claim that they purchased over \$100 million in stock because they were relying on the auditor's statements that the 2007 financial statements of Clovitech, Inc. were accurate and that proper internal controls were established and operating effectively. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders argue that ABC CPA Firm should have performed additional audit procedures and disclosed their discovery of a deficiency in internal controls. The stockholders allege that the auditors should not have relied on the audit committees' suggestions, as the committee clearly has too close of a relationship with the company to make objective decisions. They argue that the audit committee members' direct ownership in the company's stock likely compromises the members' ability to make objective decisions.

The stockholders also allege that the auditors should not have relied on the audit committees' suggestions, because the committee members clearly had a low level of knowledge and expertise about accounting and financial reporting issues. They argue that the audit committee members' lack of specific experience in accounting or finance compromises the members' ability to make educated decisions.

Overall, the stockholders allege that the auditor made the decision to side with the Clovitech executives and audit committee members, and not disclose their concerns with the company's weak internal controls established by top management, out of the auditor's own self-interest to please the client and make sure they were re-hired for the next year's audit. They argue that the audit committee's involvement in the disagreement with management did not increase the auditor's objectivity, since the audit committee's own lack of objectivity would have compromised the situation, and the audit committee's lack of experience did not allow them to fully understand the issues involved in the dispute.

In response to these allegations, ABC CPA Firm maintains that they performed their audit well within the standards of care as dictated by U.S. audit standards. The auditors argue that they fulfilled the requirements of these standards by disclosing the discovery of the deficiency in internal controls directly to the audit committee, and the discussion with the audit committee and managers convinced the auditor to believe that there was no need to take further action during the audit.

The auditors argue that the audit committee members' seemingly low level of expertise in accounting or finance did not impact their knowledge about accounting and financial reporting. They also assert that the fact that the audit committee members have close relationships with the company did not impact the audit committee members' ability to communicate objectively about the issues that arose during the audit.

Overall, ABC CPA Firm asserts that they maintained high quality, independent, and objective decision-making throughout the entire audit, and came to conclusions based on professional judgment of the evidence presented to them at the time. Because audit standards do not require auditors to disclose minor deficiencies in internal control to the public, the auditor maintains that they fully complied with established professional standards, and are not liable for negligent misrepresentation.

(Low Independence/High Expertise Case)

I. Background on Clovitech, Inc.:

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million and an overall profit of \$200 million, with positive indications for future growth. The stock for the company immediately following the release of the 2007 report was on a consistent positive trend, and analysts

considered the company a solid investment.

Clovitech, Inc. has been audited by ABC CPA Firm, a large international accounting firm, for the past three years. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal control policies in place, which are procedures that are designed to prevent or detect significant inaccuracies in the financial statements. Auditors must issue an opinion on the adequacy of the internal controls and issue an opinion on whether the financial statements are fairly presented. For 2007, ABC CPA Firm issued an opinion stating that the 2007 financial statements of Clovitech, Inc. were reliable. They also expressed an opinion stating that the internal controls within the company were sufficient to assure reliance on their financial figures.

In their 2007 annual report Clovitech, Inc. reported details on their audit committee. Audit committees are required for all public companies, and serve multiple purposes. The audit committee selects the independent audit firm, and is in charge of paying the auditor. The Committee also reviews the procedures of the independent registered audit firm for ensuring the auditor's independence with respect to the services performed for the Company. Therefore, the members of the audit committee have an important job in assuring that the external auditors are performing up to standards and making independent and objective decisions.

While audit committee members are members of the Board of Directors, only a subset of the full Board are on the audit committee. The members of the audit committee are usually members of the business community that are not currently working directly for the company in any other way. Members are permitted to own stock in the company; although it is encouraged they own less than 10% of the company stock to maintain a distant relationship with the company. Any stock ownership in the company might influence the ability for the audit committee member to make objective decisions during the auditing and reporting process.

To remain in compliance with laws, the company must also disclose whether members of the audit committee would be considered experts in finance or accounting. This expertise is considered important because of the high level of influence the audit committee has on the oversight of auditing and financial reporting in the company. However, companies are not actually required to have an expert audit committee member. They are only required to provide a disclosure about the members' level of expertise. If none of the members could be considered experts in finance or auditing, the company must disclose why they feel the members are appropriate for the job.

In 2007, Clovitech, Inc. publicly reported that the audit committee operated in compliance with the suggested requirements for public companies by assuring that all members did not have significant financial investments or professional relationships with the company. The

company also disclosed details on the level of expertise of the audit committee members.

In their report, Clovitech stated that the audit committee consisted of 3 members who own an average of 8% of stock in the company. Clovitech also reported that one member of the committee is a CPA and former CFO of a mid-sized public company, and is considered an expert in both finance and accounting.

An independent organization that collects information about public companies and their audit committees performed a detailed analysis of Clovitech's audit committee in 2007. Their analysis generates a score out of 100 based on key factors that are common characteristics of high quality audit committees. The level of expertise for the audit committee of Clovitech, Inc. was rated "high" with a score of 90/100. The committee's level of freedom from financial or professional relationships with the company was rated "low" with a score of 30/100, meaning that the committee members have a close relationship to the company.

Summary of Clovitech, Inc. audit committee characteristics, as described above:

Clovitech, Inc. Audit Committee Characteristics		Independent Audit Committee Quality Rating of Clovitech, Inc. Audit Committee
Average Amount of Clovitech, Inc. Stock Owned by Audit Committee Members	8%	Level of freedom from financial or professional relationships with the company rated "Low" (Score 30/100)*
Number of Audit Committee Members with Expertise in Accounting and/or Finance	1 member with expertise in both accounting and finance	Level of expertise rated "High" (Score 90/100)

*Note: A Low rating in this category indicates that the committee members have a close relationship to the company.

II. Relationships between the Audit Committee, Top Management, and the Auditor

Audit committees are in charge of overseeing the audit process, and are often consulted when a disagreement occurs between managers of the company and the external auditor in examining the company's records and internal controls. The relationship between these three groups is important to understand, as the quality of the audit can often depend on the qualifications and objectivity of each of the groups. One of the main ways that companies maintain an independent audit is making sure that the external auditor is not overly subjected to pressure to comply with

management's requests, so that the decisions made about the audit are in the best interests of shareholders and creditors.

Since managers of the company are often compensated directly based on their performance, and are financially motivated to show profits and meet projections, they are often deemed to have the least amount of objectivity when evaluating financial reporting issues.

Audit committees are paid by the company, but are required to keep a minimum level of investment in the company to increase objectivity.

Auditors are paid by the audit committee, which provides an additional level of distance between the auditor and management, which is intended to increase the auditor's objectivity when making decisions about the company's financial statements.

III. Clovitech, Inc. Declares Bankruptcy

On February 20th 2009, almost a year after the 2007 financial statements of Clovitech, Inc. were released, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme emerged, and it became evident that employees had been consistently inflating revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock the products with incentives (i.e. highly favorable credit terms of 6 months or more with no interest). The scheme was uncovered when significant decreases in demand for the product caught up with the company, as retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated revenue figures. Multiple employees admitted their participation in the scheme to inflate sales revenues.

The discovery that this manipulation of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year. The restatement was also accompanied by management's disclosure of a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Management had over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level, and did not establish proper controls in place to assure that employees did not exaggerate sales at the division level. This weakness contributed to the fact that this fraud was able to occur without being detected, and that the financial statement figures of Clovitech, Inc. were substantially overstated.

ABC CPA Firm had discovered this particular deficiency in the internal controls established by top management during their audit of internal controls for the 2007 financial statements, and reported it to the audit committee. The auditor was particularly concerned that there may be excess pressure placed on employees to overstate revenues, and that the financial statements could be misleading as a result. The issue was brought up in an audit committee meeting, with the auditors and Clovitech executives present, to determine whether the deficiency in internal controls warranted further investigation and should be disclosed in the audit report.

In this audit committee meeting, the Clovitech executives argued that there was no evidence to suggest that any errors existed in the financial statements, and presented evidence of a formal written policy that clearly instructs employees to record income only when it is appropriate. The audit committee sided with the Clovitech executives, arguing that the existence of the policy indicates that internal controls are appropriately in place to prevent manipulation of revenue figures. Without specific evidence to argue otherwise, the auditor agreed and did not disclose any issues with internal controls over revenue recognition in their audit reports for 2007.

IV. Stockholders Sue ABC CPA Firm for Negligent Misrepresentation

Stockholders of Clovitech, Inc. consulted a lawyer and decided to sue the auditor, ABC CPA Firm, as a group in a class action lawsuit, alleging that the auditors negligently supplied false information to stockholders. The stockholders claim that they purchased over \$100 million in stock because they were relying on the auditor's statements that the 2007 financial statements of Clovitech, Inc. were accurate and that proper internal controls were established and operating effectively. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders argue that ABC CPA Firm should have performed additional audit procedures and disclosed their discovery of a deficiency in internal controls. The stockholders allege that the auditors should not have relied on the audit committees' suggestions, as the committee clearly has too close of a relationship with the company to make objective decisions. They argue that the audit committee members' direct ownership in the company's stock likely compromises the members' ability to make objective decisions.

Overall, the stockholders allege that the auditor made the decision to side with the Clovitech executives and audit committee members, and not disclose their concerns with the company's weak internal controls established by top management, out of the auditor's own self-interest to please the client and make sure they were re-hired for next year's audit. They argue that the audit committee's involvement in the disagreement with management did not increase the auditor's objectivity, since the audit committee's own lack of objectivity would have compromised the situation.

In response to these allegations, ABC CPA Firm maintains that they performed their audit well within the standards of care as dictated by U.S. audit standards. The auditors argue that they

fulfilled the requirements of these standards by disclosing the discovery of the deficiency in internal controls directly to the audit committee, and the discussion with the audit committee and managers convinced the auditor to believe that there was no need to take further action during the audit.

The auditors argue that an audit committee made up of highly expert members in accounting and finance should be a viable source of influence and communication about issues that arise during the audit, and that the audit committee members' opinions were made with sufficient levels of knowledge about accounting and financial reporting. They also assert that the fact that the audit committee members have close relationships with the company did not impact the audit committee members' ability to communicate objectively about the issues that arose during the audit.

Overall, ABC CPA Firm asserts that they maintained high quality, independent, and objective decision-making throughout the entire audit, and came to conclusions based on professional judgment of the evidence presented to them at the time. Because audit standards do not require auditors to disclose minor deficiencies in internal control to the public, the auditor maintains that they fully complied with established professional standards, and are not liable for negligent misrepresentation.

(High Independence/High Expertise Case)

I. Background on Clovitech, Inc.:

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million and an overall profit of \$200 million, with positive indications for future growth. The stock for the company immediately following the release of the 2007 report was on a consistent positive trend, and analysts considered the company a solid investment.

Clovitech, Inc. has been audited by ABC CPA Firm, a large international accounting firm, for the past three years. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal control policies in place, which are procedures that are designed to prevent or detect significant inaccuracies in the financial statements. Auditors must issue an opinion on the adequacy of the internal controls and issue an opinion on whether the financial statements are fairly presented. For 2007, ABC CPA Firm issued an opinion stating that the 2007 financial statements of Clovitech, Inc. were reliable. They also expressed an opinion stating that the internal controls within the company were sufficient to assure reliance on their financial figures.

In their 2007 annual report Clovitech, Inc. reported details on their audit committee. Audit committees are required for all public companies, and serve multiple purposes. The audit

committee selects the independent audit firm, and is in charge of paying the auditor. The Committee also reviews the procedures of the independent registered audit firm for ensuring the auditor's independence with respect to the services performed for the Company. Therefore, the members of the audit committee have an important job in assuring that the external auditors are performing up to standards and making independent and objective decisions.

While audit committee members are members of the Board of Directors, only a subset of the full Board are on the audit committee. The members of the audit committee are usually members of the business community that are not currently working directly for the company in any other way. Members are permitted to own stock in the company; although it is encouraged they own less than 10% of the company stock to maintain a distant relationship with the company. Any stock ownership in the company might influence the ability for the audit committee member to make objective decisions during the auditing and reporting process.

To remain in compliance with laws, the company must also disclose whether members of the audit committee would be considered experts in finance or accounting. This expertise is considered important because of the high level of influence the audit committee has on the oversight of auditing and financial reporting in the company. However, companies are not actually required to have an expert audit committee member. They are only required to provide a disclosure about the members' level of expertise. If none of the members could be considered experts in finance or auditing, the company must disclose why they feel the members are appropriate for the job.

In 2007, Clovitech, Inc. publicly reported that the audit committee operated in compliance with the suggested requirements for public companies by assuring that all members did not have significant financial investments or professional relationships with the company. The company also disclosed details on the level of expertise of the audit committee members.

In their report, Clovitech stated that the audit committee consisted of 3 members who do not own any stock in the company. Clovitech also reported that one member of the committee is a CPA and former CFO of a mid-sized public company, and is considered an expert in both finance and accounting.

An independent organization that collects information about public companies and their audit committees performed a detailed analysis of Clovitech's audit committee in 2007. Their analysis generates a score out of 100 based on key factors that are common characteristics of high quality audit committees. The level of expertise for the audit committee of Clovitech, Inc. was rated "high" with a score of 90/100. The committee's level of freedom from financial or professional relationships with the company was also rated "high" with a score of 90/100, meaning that the committee members have a distant relationship from the company.

Summary of Clovitech, Inc. audit committee characteristics, as described above:

Clovitech, Inc. Audit Committee Characteristics		Independent Audit Committee Quality Rating of Clovitech, Inc. Audit Committee
Average Amount of Clovitech, Inc. Stock Owned by Audit Committee Members	None	Level of freedom from financial or professional relationships with the company rated "High" (Score 90/100)*
Number of Audit Committee Members with Expertise in Accounting and/or Finance	1 member with expertise in both accounting and finance	Level of expertise rated "High" (Score 90/100)

*Note: A High rating indicates that the committee members have a distant relationship from the company.

II. Relationships between the Audit Committee, Top Management, and the Auditor

Audit committees are in charge of overseeing the audit process, and are often consulted when a disagreement occurs between managers of the company and the external auditor in examining the company's records and internal controls. The relationship between these three groups is important to understand, as the quality of the audit can often depend on the qualifications and objectivity of each of the groups. One of the main ways that companies maintain an independent audit is making sure that the external auditor is not overly subjected to pressure to comply with management's requests, so that the decisions made about the audit are in the best interests of shareholders and creditors.

Since managers of the company are often compensated directly based on their performance, and are financially motivated to show profits and meet projections, they are often deemed to have the least amount of objectivity when evaluating financial reporting issues.

Audit committees are paid by the company, but are required to keep a minimum level of investment in the company to increase objectivity.

Auditors are paid by the audit committee, which provides an additional level of distance between the auditor and management, which is intended to increase the auditor's objectivity when making decisions about the company's financial statements.

III. Clovitech, Inc. Declares Bankruptcy

On February 20th 2009, almost a year after the 2007 financial statements of Clovitech, Inc. were released, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme emerged, and it became evident that employees had been consistently inflating revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock the products with incentives (i.e. highly favorable credit terms of 6 months or more with no interest). The scheme was uncovered when significant decreases in demand for the product caught up with the company, as retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated revenue figures. Multiple employees admitted their participation in the scheme to inflate sales revenues.

The discovery that this manipulation of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year. The restatement was also accompanied by management's disclosure of a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Management had over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level, and did not establish proper controls in place to assure that employees did not exaggerate sales at the division level. This weakness contributed to the fact that this fraud was able to occur without being detected, and that the financial statement figures of Clovitech, Inc. were substantially overstated.

ABC CPA Firm had discovered this particular deficiency in the internal controls established by top management during their audit of internal controls for the 2007 financial statements, and reported it to the audit committee. The auditor was particularly concerned that there may be excess pressure placed on employees to overstate revenues, and that the financial statements could be misleading as a result. The issue was brought up in an audit committee meeting, with the auditors and Clovitech executives present, to determine whether the deficiency in internal controls warranted further investigation and should be disclosed in the audit report.

In this audit committee meeting, the Clovitech executives argued that there was no evidence to suggest that any errors existed in the financial statements, and presented evidence of a formal written policy that clearly instructs employees to record income only when it is appropriate. The audit committee sided with the Clovitech executives, arguing that the existence of the policy indicates that internal controls are appropriately in place to prevent manipulation of revenue figures. Without specific evidence to argue otherwise, the auditor agreed and did not disclose any issues with internal controls over revenue recognition in their audit reports for 2007.

IV. Stockholders Sue ABC CPA Firm for Negligent Misrepresentation

Stockholders of Clovitech, Inc. consulted a lawyer and decided to sue the auditor, ABC CPA Firm, as a group in a class action lawsuit, alleging that the auditors negligently supplied false information to stockholders. The stockholders claim that they purchased over \$100 million in stock because they were relying on the auditor's statements that the 2007 financial statements of Clovitech, Inc. were accurate and that proper internal controls were established and operating effectively. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders argue that ABC CPA Firm should have performed additional audit procedures and disclosed their discovery of a deficiency in internal controls. The stockholders allege that the auditors should not have relied on the audit committees' suggestions.

Overall, the stockholders allege that the auditor made the decision to side with the Clovitech executives and audit committee members, and not disclose their concerns with the company's weak internal controls established by top management, out of the auditor's own self-interest to please the client and make sure they were re-hired for the next year's audit. They argue that the audit committee's involvement in the disagreement with management did not increase the auditor's objectivity.

In response to these allegations, ABC CPA Firm maintains that they performed their audit well within the standards of care as dictated by U.S. audit standards. The auditors argue that they fulfilled the requirements of these standards by disclosing the discovery of the deficiency in internal controls directly to the audit committee, and the discussion with the audit committee and managers convinced the auditor to believe that there was no need to take further action during the audit.

The auditors argue that an audit committee made up of members who do not have close relationships with the company, and highly expert members in accounting and finance, should be a viable source of communication about issues that arise during the audit. They further note that the audit committee members' communications about the issue were objective, and made with sufficient knowledge about accounting and financial reporting.

Overall, ABC CPA Firm asserts that they maintained high quality, independent, and objective decision-making throughout the entire audit, and came to conclusions based on professional judgment of the evidence presented to them at the time. Because audit standards do not require auditors to disclose minor deficiencies in internal control to the public, the auditor maintains that they fully complied with established professional standards, and are not liable for negligent misrepresentation.

(High Independence/Low Expertise Case)

I. Background on Clovitech, Inc.:

Clovitech, Inc. is a large public company that manufactures computer accessories and distributes them to large retailers across the U.S. The 2007 financial statements of the company disclosed sales revenues of \$400 million and an overall profit of \$200 million, with positive indications for future growth. The stock for the company immediately following the release of the 2007 report was on a consistent positive trend, and analysts considered the company a solid investment.

Clovitech, Inc. has been audited by ABC CPA Firm, a large international accounting firm, for the past three years. Auditors are hired by companies to determine whether the financial statements of the company are accurate. Auditors also investigate whether the company has proper internal control policies in place, which are procedures that are designed to prevent or detect significant inaccuracies in the financial statements. Auditors must issue an opinion on the adequacy of the internal controls and issue an opinion on whether the financial statements are fairly presented. For 2007, ABC CPA Firm issued an opinion stating that the 2007 financial statements of Clovitech, Inc. were reliable. They also expressed an opinion stating that the internal controls within the company were sufficient to assure reliance on their financial figures.

In their 2007 annual report Clovitech, Inc. reported details on their audit committee. Audit committees are required for all public companies, and serve multiple purposes. The audit committee selects the independent audit firm, and is in charge of paying the auditor. The Committee also reviews the procedures of the independent registered audit firm for ensuring the auditor's independence with respect to the services performed for the Company. Therefore, the members of the audit committee have an important job in assuring that the external auditors are performing up to standards and making independent and objective decisions.

While audit committee members are members of the Board of Directors, only a subset of the full Board are on the audit committee. The members of the audit committee are usually members of the business community that are not currently working directly for the company in any other way. Members are permitted to own stock in the company; although it is encouraged they own less than 10% of the company stock to maintain a distant relationship with the company. Any stock ownership in the company might influence the ability for the audit committee member to make objective decisions during the auditing and reporting process.

To remain in compliance with laws, the company must also disclose whether members of the audit committee would be considered experts in finance or accounting. This expertise is considered important because of the high level of influence the audit committee has on the oversight of auditing and financial reporting in the company. However, companies are not

actually required to have an expert audit committee member. They are only required to provide a disclosure about the members' level of expertise. If none of the members could be considered experts in finance or auditing, the company must disclose why they feel the members are appropriate for the job.

In 2007, Clovitech, Inc. publicly reported that the audit committee operated in compliance with the suggested requirements for public companies by assuring that all members did not have significant financial investments or professional relationships with the company. The company also disclosed details on the level of expertise of the audit committee members.

In their report, Clovitech stated that the audit committee consisted of 3 members who do not own any stock in the company. Although no single member of the audit committee qualifies as an expert in finance or accounting, Clovitech reported that the collective knowledge of the audit committee covers the necessary knowledge needed to fulfill their roles.

An independent organization that collects information about public companies and their audit committees performed a detailed analysis of Clovitech's audit committee in 2007. Their analysis generates a score out of 100 based on key factors that are common characteristics of high quality audit committees. The level of expertise for the audit committee of Clovitech, Inc. was rated "low" with a score of 30/100. The committee's level of freedom from financial or professional relationships with the company was also rated "high" with a score of 90/100, meaning that the committee members have a distant relationship from the company.

Summary of Clovitech, Inc. audit committee characteristics, as described above:

Clovitech, Inc. Audit Committee Characteristics		Independent Audit Committee Quality Rating of Clovitech, Inc. Audit Committee
Average Amount of Clovitech, Inc. Stock Owned by Audit Committee Members	None	Level of freedom from financial or professional relationships with the company rated "High" (Score 90/100)*
Number of Audit Committee Members with Expertise in Accounting and/or Finance	None	Level of expertise rated "Low" (Score 30/100)

*Note: A High rating indicates that the committee members have a distant relationship from the company.

II. Relationships between the Audit Committee, Top Management, and the Auditor

Audit committees are in charge of overseeing the audit process, and are often consulted when a disagreement occurs between managers of the company and the external auditor in examining

the company's records and internal controls. The relationship between these three groups is important to understand, as the quality of the audit can often depend on the qualifications and objectivity of each of the groups. One of the main ways that companies maintain an independent audit is making sure that the external auditor is not overly subjected to pressure to comply with management's requests, so that the decisions made about the audit are in the best interests of shareholders and creditors.

Since managers of the company are often compensated directly based on their performance, and are financially motivated to show profits and meet projections, they are often deemed to have the least amount of objectivity when evaluating financial reporting issues.

Audit committees are paid by the company, but are required to keep a minimum level of investment in the company to increase objectivity.

Auditors are paid by the audit committee, which provides an additional level of distance between the auditor and management, which is intended to increase the auditor's objectivity when making decisions about the company's financial statements.

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On February 20th 2009, almost a year after the 2007 financial statements of Clovitech, Inc. were released, a news article surfaced indicating that Clovitech, Inc. filed for Chapter 7 bankruptcy due to a sudden significant decrease in orders from stores selling their products. Details on an inventory fraud scheme emerged, and it became evident that employees had been consistently inflating revenues to meet projections and conceal significant declines in demand for their products for the past year.

Specifically, individual sales teams were distributing excess inventory to retailers near the end of each quarter to meet short-term revenue projections. The sales teams were able to convince retailers to over-stock the products with incentives (i.e. highly favorable credit terms of 6 months or more with no interest). The scheme was uncovered when significant decreases in demand for the product caught up with the company, as retailers were no longer able to sell the product in their stores and stopped ordering more stock from the sales representatives. This scheme is considered fraudulent, since the employees are receiving excess compensation based on intentionally manipulated revenue figures. Multiple employees admitted their participation in the scheme to inflate sales revenues.

The discovery that this manipulation of sales revenue figures had been occurring since the beginning of 2007 prompted the company to decrease their 2007 reported sales revenues by over \$200 million, resulting in an overall loss of \$10 million for the year. The restatement was also accompanied by management's disclosure of a material weakness in internal controls over inventory, stating that the internal controls established by the top-level managers within the company were ineffective. Management had over-emphasized meeting short-term profit goals at the sacrifice of internal control at the sales division level, and did not establish proper controls in place to assure that employees did not exaggerate sales at the division level. This weakness

contributed to the fact that this fraud was able to occur without being detected, and that the financial statement figures of Clovitech, Inc. were substantially overstated.

ABC CPA Firm had discovered this particular deficiency in the internal controls established by top management during their audit of internal controls for the 2007 financial statements, and reported it to the audit committee. The auditor was particularly concerned that there may be excess pressure placed on employees to overstate revenues, and that the financial statements could be misleading as a result. The issue was brought up in an audit committee meeting, with the auditors and Clovitech executives present, to determine whether the deficiency in internal controls warranted further investigation and should be disclosed in the audit report.

In this audit committee meeting, the Clovitech executives argued that there was no evidence to suggest that any errors existed in the financial statements, and presented evidence of a formal written policy that clearly instructs employees to record income only when it is appropriate. The audit committee sided with the Clovitech executives, arguing that the existence of the policy indicates that internal controls are appropriately in place to prevent manipulation of revenue figures. Without specific evidence to argue otherwise, the auditor agreed and did not disclose any issues with internal controls over revenue recognition in their audit reports for 2007.

IV. Stockholders Sue ABC CPA Firm for Negligent Misrepresentation

Stockholders of Clovitech, Inc. consulted a lawyer and decided to sue the auditor, ABC CPA Firm, as a group in a class action lawsuit, alleging that the auditors negligently supplied false information to stockholders. The stockholders claim that they purchased over \$100 million in stock because they were relying on the auditor's statements that the 2007 financial statements of Clovitech, Inc. were accurate and that proper internal controls were established and operating effectively. On the day the restatement was announced, Clovitech, Inc. stock dropped 50% in value from \$28 to \$14 per share. Only one week later, following the bankruptcy announcement, the stock was considered worthless, with total losses for this group of shareholders estimated at \$100 million.

The stockholders argue that ABC CPA Firm should have performed additional audit procedures and disclosed their discovery of a deficiency in internal controls. The stockholders allege that the auditors should not have relied on the audit committees' suggestions, as the committee members clearly had a low level of knowledge and expertise about accounting and financial reporting issues. They argue that the audit committee members' lack of specific experience in accounting or finance compromises the members' ability to make educated decisions.

Overall, the stockholders allege that the auditor made the decision to side with the Clovitech executives and audit committee members, and not disclose their concerns with the company's weak internal controls established by top management, out of the auditor's own self-interest to please the client and make sure they were re-hired for the next year's audit. They argue that the audit committee's involvement in the disagreement with management did not increase the auditor's objectivity, since the audit committee's lack of experience did not allow them to fully understand the issues involved in the dispute.

In response to these allegations, ABC CPA Firm maintains that they performed their audit well within the standards of care as dictated by U.S. audit standards. The auditors argue that they fulfilled the requirements of these standards by disclosing the discovery of the deficiency in internal controls directly to the audit committee, and the discussion with the audit committee and managers convinced the auditor to believe that there was no need to take further action during the audit.

The auditors argue that an audit committee made up of members who do not have close relationships with the company should be a viable source of influence and communication about issues that arise during the audit, and that they believe that the audit committee members' opinions were objective. They also assert that the audit committee members' seemingly low level of expertise in accounting or finance did not impact their knowledge about accounting and financial reporting.

Overall, ABC CPA Firm asserts that they maintained high quality, independent, and objective decision-making throughout the entire audit, and came to conclusions based on professional judgment of the evidence presented to them at the time. Because audit standards do not require auditors to disclose minor deficiencies in internal control to the public, the auditor maintains that they fully complied with established professional standards, and are not liable for negligent misrepresentation.

Questionnaire (Common to all four conditions)

Please answer the following questions as if you were a jury member in the trial for the lawsuit filed by the stockholders of Clovitech, Inc. against the auditors, ABC CPA Firm. Please note, these questions are asked to gain your opinion on the case you reviewed in the previous section, so there is no “right” or “wrong” answer to these questions.

In this case, stockholders are suing the defendant, ABC CPA Firm, for negligent misrepresentation. A defendant may be found liable for negligent misrepresentation when the defendant makes false statements without exercising reasonable care of competence in obtaining or communicating the information.

How would you vote?

- The auditor is liable for negligent misrepresentation.
- The auditor is NOT liable for negligent misrepresentation.

The stockholders in this case are suing for \$100 million in compensatory damages and undetermined punitive damages. When answering the following questions, please note the provided definitions:

(NOTE: IF PARTICIPANTS RESPONDED “NOT LIABLE” THEY DID NOT ANSWER THE NEXT TWO QUESTIONS RELATED TO DAMAGES)

Compensatory damages: Amount of money adequate to compensate for any *actual damages* caused by the party against whom they awarded. In this case, stockholders are suing for compensation of \$100 million in actual losses.

As one of the jurors, what dollar amount in *compensatory damages* would you recommend be awarded to the stockholders? You must decide on a dollar amount from \$0 to \$100,000,000.

Please enter a whole number (no decimals) with no dollar signs or commas. _____

Punitive Damages: Amount of money awarded to *punish* a defendant and to deter a defendant and others from committing similar acts in the future. Punitive damages are usually awarded in cases where the defendant's actions were very offensive. Punitive damages are awarded *in addition* to the compensatory damages, so your answer to the previous question on compensatory damages does not impact your decision for punitive damages. In this case, assume that the punitive damages are limited to \$200 million.

As one of the jurors, what dollar amount in *punitive damages* would you recommend be awarded to the stockholders? You must decide on a dollar amount from \$0 to \$200,000,000.

Please enter a whole number (no decimals) with no dollar signs or commas. _____

The following questions are asked to gain your perspectives about the actions of ABC CPA Firm (the auditor of Clovitech, Inc.) based on what you read in the scenario presented to you.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
ABC CPA Firm is liable for negligent misrepresentation.	0	0	0	0	0	0	0
ABC CPA Firm performed their services in compliance within the standards that dictate how audits should be performed.	0	0	0	0	0	0	0
ABC CPA Firm made the appropriate disclosures in compliance within the standards that dictate what auditors should disclose.	0	0	0	0	0	0	0
ABC CPA Firm could have prevented the stockholder losses.	0	0	0	0	0	0	0
ABC CPA Firm is responsible for stockholder losses.	0	0	0	0	0	0	0

The audit committee of Clovitech, Inc. was not named in the above lawsuit. Nevertheless, please assess the following.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The <u>audit committee</u> is liable for negligent misrepresentation.	0	0	0	0	0	0	0
The <u>audit committee</u> is responsible for stockholder losses.	0	0	0	0	0	0	0

The executives (upper level management) of Clovitech, Inc. were not named in the above lawsuit. Nevertheless, please assess the following.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The <u>executives of Clovitech, Inc.</u> are liable for negligent misrepresentation.	0	0	0	0	0	0	0
The <u>executives of Clovitech, Inc.</u> are responsible for stockholder losses.	0	0	0	0	0	0	0

The following questions are asked to gain your perspectives about ABC CPA Firm (the auditor of Clovitech, Inc.) based on what you read in the scenario presented to you.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
<i>ABC CPA Firm was objective during their 2007 audit of Clovitech, Inc.</i>	0	0	0	0	0	0	0
<i>ABC CPA Firm's decisions were biased during the 2007 audit of Clovitech, Inc.</i>	0	0	0	0	0	0	0
<i>Management exerted pressure on ABC CPA Firm NOT to disclose a deficiency in the internal controls established by top management.</i>	0	0	0	0	0	0	0
<i>ABC CPA Firm's decisions during the audit were influenced by the managers of Clovitech, Inc.</i>	0	0	0	0	0	0	0
<i>ABC CPA Firm was protecting its own interest by not warning stockholders of the client's deficiencies in the internal controls established by top management.</i>	0	0	0	0	0	0	0

The following questions are asked to gain your perspectives about the *audit committee* of Clovitech, Inc. (the company who declared bankruptcy) based on what you read in the scenario presented to you.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The audit committee had the relevant expertise for their job.	0	0	0	0	0	0	0
The audit committee had expertise in finance.	0	0	0	0	0	0	0
The audit committee had expertise in accounting.	0	0	0	0	0	0	0
The audit committee was able to comprehend the issues that arose during the audit.	0	0	0	0	0	0	0
The audit committee's level of expertise allowed them to make informed decisions about issues that arose during the audit.	0	0	0	0	0	0	0
The audit committee's experience influenced the quality of the decisions made during the audit.	0	0	0	0	0	0	0

The following questions are asked to gain your perspectives about the *audit committee* of Clovitech, Inc. (the company who declared bankruptcy) based on what you read in the scenario presented to you.

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The audit committee members were objective during the 2007 audit of Clovitech, Inc.?	0	0	0	0	0	0	0
The audit committee's decisions were biased during the 2007 audit of Clovitech, Inc.	0	0	0	0	0	0	0
Management exerted pressure on the audit committee NOT to recommend disclosing a deficiency in the internal controls established by top management.	0	0	0	0	0	0	0
The audit committee's decisions during the audit were influenced by the managers of Clovitech, Inc.	0	0	0	0	0	0	0
The audit committee members were protecting their own interests by not warning stockholders of the client's deficiencies in the internal controls established by top management.	0	0	0	0	0	0	0

Please answer the remaining questions in this survey without looking back at the case:

Did the audit committee of Clovitech, Inc. own any stock in the company?

- Yes
 No

Did the audit committee of Clovitech, Inc. contain a member with expertise in accounting and/or finance?

- Yes
 No

The following questions are asked to gain your perspectives about this task

Please select "Yes" or "No" depending on your experience with the task you completed.

Did you listen to the audio recording provided for this task? Yes No

Did you read the text provided for this task? Yes No

Did you click to open the PDF file and read the auditor's report on internal controls? Yes No

Please indicate your level of agreement with the following statements:

	Strongly Agree	Somewhat Agree	Slightly Agree	Neither Agree or Disagree	Slightly Disagree	Somewhat Disagree	Strongly Disagree
The task was difficult.	0	0	0	0	0	0	0
The task was enjoyable.	0	0	0	0	0	0	0
The task was realistic.	0	0	0	0	0	0	0

Did you experience any technical difficulties with the technology for this task? Yes No

If yes, please describe:

The following questions are asked to allow the researchers to further understand the demographics of the individuals responding to this study. The answers are entirely voluntary, but are very important to the research.

What is your age?

What is your gender?

Are you currently a U. S. Citizen?

What is your current state of residence?

Are you currently registered to vote in the US?

Are you currently registered to vote in the US?

If you are currently registered to vote within the U.S., with which political party are you affiliated?

- Republican
- Democrat
- Independent
- Other

If other, please specify

Have you ever been called for jury duty in the U.S?

Have you ever served on a jury in the U.S.?

- No
- Yes, for a civil trial
- Yes, for a criminal trial

Are you currently or have you ever been:

A Certified Public Accountant?

An Auditor?

A Manager in a business where a financial audit was conducted?

A Professional Investor (provided investment advice or made investments for others as your main source of employment)?

An attorney?

A member of an audit committee?

Are you currently a student?

What is the highest level of education you have attained?

- Some High School
- Completed High School (or Equivalent)
- Completed Trade or Professional School
- Some College
- Graduated College
- Some Post-Graduate School
- Completed Graduate School

What is your approximate annual gross family income?

- less than \$10,000
- \$10,000 - \$24,999
- \$25,000 - \$39,999
- \$40,000 - \$54,999
- \$55,000 - \$69,999
- \$70,000 - \$84,999
- \$85,000 - \$ 99,999
- \$100,000 - \$199,999
- \$200,000 or more

Which of the following describes your current employment status? Please select ALL that apply.

- Employed full-time
- Employed part-time
- Self-employed
- Full-time student
- Retired
- Stay-at-home parent or homemaker
- Unemployed (and looking for employment)
- Other

If other, please specify

If you are currently employed or self-employed, what is your field of employment (for example, education, health care, manufacturing, etc.)?

What is your race/ethnicity?

- American Indian or Alaskan Native
- Asian or Pacific Islander
- Black
- White
- Hispanic
- Other

If other, please specify

The following questions are commonly asked in the jury selection process for court cases. Please answer either “yes” or “no” to each of the following questions:

Have you or a family member or close personal friend either currently or in the past been involved as a party (either a plaintiff or a defendant) in a lawsuit involving damages for professional negligence (medical malpractice, accounting malpractice, etc.)?

Have you or a family member or close personal friend either currently or in the past been involved as a party (either a plaintiff or a defendant) in a class action lawsuit?

A plaintiff is a person or corporation who has initiated a lawsuit. Would you have a bias for or against a plaintiff simply because he or she has brought a lawsuit?

A defendant is a person or corporation against whom a lawsuit has been brought. Would you have a bias for or against a defendant simply because a lawsuit has been brought against him or her?

If the law and evidence warranted, would you be able to render a verdict for a defendant regardless of any sympathy you may have for either party?

Would your verdict in this case be influenced in any way by any factors other than the evidence in the courtroom such as friendships or family relationships or the type of work you do?

Have you ever testified in any court proceeding?

Have you ever been a witness in a civil matter, regardless of whether it went to trial?

Do you, or have you ever, owned stock in a company?

Have you ever owned stock in a company that has declared bankruptcy?

If you were called for jury duty, would you try to avoid having to serve on the jury?

APPENDIX E: IRB APPROVAL



University of Central Florida Institutional Review Board
Office of Research & Commercialization
12201 Research Parkway, Suite 501
Orlando, Florida 32826-3246
Telephone: 407-823-2901, 407-882-2012 or 407-882-2276
www.research.ucf.edu/compliance/irb.html

Notice of Expedited Initial Review and Approval

From : UCF Institutional Review Board
FWA00000351, Exp. 10/8/11, IRB00001138

To : Jillian Phillips

Date : April 27, 2009

IRB Number: SBE-09-06215

Study Title: **Three Experiments Investigating the Legal Liability Implications of the Sarbanes-Oxley Act of 2002**

Dear Researcher:

Your research protocol noted above was approved by **expedited** review by the UCF IRB Vice-chair on 4/24/2009. **The expiration date is 4/23/2010.** Your study was determined to be minimal risk for human subjects and expeditable per federal regulations, 45 CFR 46.110. The category for which this study qualifies as expeditable research is as follows:

7. Research on individual or group characteristics or behavior (including, but not limited to, research on perception, cognition, motivation, identity, language, communication, cultural beliefs or practices, and social behavior) or research employing survey, interview, oral history, focus group, program evaluation, human factors evaluation, or quality assurance methodologies.

The IRB has approved a **waiver of documentation of consent** for all subjects. Participants do not have to sign a consent form, but the IRB requires that you give participants a copy of the IRB-approved consent form, letter, information sheet. For online surveys, please advise participants to print out the consent document for their files.

All data, which may include signed consent form documents, must be retained in a locked file cabinet for a minimum of three years (six if HIPAA applies) past the completion of this research. Any links to the identification of participants should be maintained on a password-protected computer if electronic information is used. Additional requirements may be imposed by your funding agency, your department, or other entities. Access to data is limited to authorized individuals listed as key study personnel.

To continue this research beyond the expiration date, a Continuing Review Form must be submitted 2 – 4 weeks prior to the expiration date. Advise the IRB if you receive a subpoena for the release of this information, or if a breach of confidentiality occurs. Also report any unanticipated problems or serious adverse events (within 5 working days). Do not make changes to the protocol methodology or consent form before obtaining IRB approval. Changes can be submitted for IRB review using the Addendum/Modification Request Form. An Addendum/Modification Request Form **cannot** be used to extend the approval period of a study. All forms may be completed and submitted online at <http://iris.research.ucf.edu>.

Failure to provide a continuing review report could lead to study suspension, a loss of funding and/or publication possibilities, or reporting of noncompliance to sponsors or funding agencies. The IRB maintains the authority under 45 CFR 46.110(e) to observe or have a third party observe the consent process and the research.

On behalf of Tracy Dietz, Ph.D., UCF IRB Chair, this letter is signed by:

Signature applied by Joanne Muratori on 04/27/2009 11:19:47 AM EDT

IRB Coordinator