THE IMPACT OF AUDIT EVIDENCE DOCUMENTATION ON JURORS’ NEGLIGENCE VERDICTS AND DAMAGE AWARDS

by

ANN STEVENS GAMBLE BACKOF

(Under the Direction of E. Michael Bamber)

ABSTRACT

Audit workpapers play a key role in auditor negligence trials, yet little is known about how the documentation in these workpapers affects jurors’ decision making. I experimentally investigate how auditors’ documentation of their risk-based audit approach and their consideration of alternative accounting treatments influences jurors’ auditor negligence verdicts and damage awards. I find that auditors are more likely to be found negligent when they document their consideration of the alternative accounting treatments because such documentation increases jurors’ perceptions of the foreseeability of the misstatement, a key determinant of auditors’ personal control. However, when this same documentation is combined with documentation of the risk-based audit approach that explicitly links the audit risks to the work performed to address each risk, jurors perceive auditors’ actions prior to the negligent act as most compliant with the auditing standards and consequently award the lowest damage awards. These findings inform academics, regulators, and auditors on the importance of audit documentation decisions on jurors’ decision making.

INDEX WORDS: Audit documentation; Auditor liability; Culpable control model; Damage awards
THE IMPACT OF AUDIT EVIDENCE DOCUMENTATION ON JURORS’ NEGLIGENCE VERDICTS AND DAMAGE AWARDS

by

ANN STEVENS GAMBLE BACKOF

B.S., The University of Virginia, 2003

M.Acc., The University of Virginia, 2007

A Dissertation Submitted to the Graduate Faculty of The University of Georgia in Partial Fulfillment of the Requirements for the Degree

DOCTOR OF PHILOSOPHY

ATHENS, GEORGIA

2012
THE IMPACT OF AUDIT EVIDENCE DOCUMENTATION ON JURORS’ NEGLIGENCE VERDICTS AND DAMAGE AWARDS

by

ANN STEVENS GAMBLE BACKOF

Major Professor: E. Michael Bamber
Committee: Tina D. Carpenter
            Adam Goodie
            Jacqueline S. Hammersley

Electronic Version Approved:

Maureen Grasso
Dean of the Graduate School
The University of Georgia
May 2012
DEDICATION

To my husband Brad, for his unconditional love and support
ACKNOWLEDGEMENTS

First and foremost, I want to thank Michael Bamber, my chairperson, for his constant guidance and support. This project would not be where it is today without his invaluable advice and insight. I would also like to thank him for always believing in me and always having my best interests in mind.

Second, I want to thank my committee members, Tina Carpenter, Jackie Hammersley, and Adam Goodie, for their willingness to share their expertise with me and to provide constructive feedback on this project. I especially want to thank Tina for her unwavering support and encouragement and Jackie for her invaluable feedback on the exposition of my paper and the design of my instrument.

And last, but certainly not least, I want to thank my family. To my dad, I cannot thank you enough for your help in securing access to actual juror participants for this study. To my mom, thank you for always being there to answer my call no matter what time of the day it may be. And to Brad, thank you for being my rock throughout this entire process. I am so blessed to have you in my life and I couldn’t have made it through without you.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ACKNOWLEDGEMENTS</td>
<td></td>
<td>v</td>
</tr>
<tr>
<td>1</td>
<td>INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>THEORY AND HYPOTHESES DEVELOPMENT</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>Background</td>
<td>7</td>
</tr>
<tr>
<td></td>
<td>Jurors’ Evaluations of Auditor Negligence</td>
<td>8</td>
</tr>
<tr>
<td></td>
<td>Jurors’ Assessment of Damage Awards</td>
<td>16</td>
</tr>
<tr>
<td>3</td>
<td>EXPERIMENTAL DESIGN AND METHOD</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Participants</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Materials and Experimental Procedure</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>Independent Variables</td>
<td>22</td>
</tr>
<tr>
<td></td>
<td>Dependent Variables</td>
<td>23</td>
</tr>
<tr>
<td>4</td>
<td>RESULTS</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Descriptive Statistics</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Test of Jurors’ Evaluations of Auditor Negligence</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>Test of Jurors’ Damage Awards</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>Additional Analysis</td>
<td>32</td>
</tr>
<tr>
<td>5</td>
<td>CONCLUSION</td>
<td>38</td>
</tr>
<tr>
<td>REFERENCES</td>
<td></td>
<td>41</td>
</tr>
</tbody>
</table>
APPENDIX

A  Consent Form Given to Participants .................................................................46
B  Experimental Materials ....................................................................................49
C  Documentation of Risk-Based Audit Approach Manipulations .....................75
D  Documentation of Consideration of Alternative Accounting Treatments
   Manipulations .....................................................................................................78
CHAPTER 1
INTRODUCTION

Jurors evaluate evidence presented during auditor negligence trials to determine whether auditors have met the audit quality level required by auditing standards (Kadous 2000). Audit workpapers represent a key piece of evidence supporting the quality of auditors’ work (PCAOB 2004). These workpapers are especially important to auditors’ defense because, unlike trial testimony, the audit workpapers are the only part of the negligence trial over which auditors have complete control. However, little is known about how audit documentation decisions influence jurors’ decision making. My study addresses this void in the literature by specifically examining how auditors’ documentation of their work affects jurors’ evaluations of auditor negligence and assignment of damage awards.

Legal standards indicate that jurors should evaluate auditors based on the quality, rather than the consequences, of their work (Causey and Causey 1991). However, a persistent finding in the prior auditing literature is that jurors’ knowledge of the adverse outcome associated with an audit failure affects jurors’ evaluations of auditors (Lowe and Reckers 1994; Kadous 2000, 2001; Clarkson et al. 2002; Peecher and Piercey 2008; Becker et al. 2009).¹ Although jury instructions and remedial tactics reduce this outcome effect (Kadous 2001; Clarkson et al. 2002; Cornell et al. 2009), the effectiveness of these approaches depends on the ex post willingness of the judge to implement the attributional jury instructions (ABA 2010) and the ex post willingness

¹ Audit failures occur when auditors issue an unqualified opinion on financial statements that are subsequently found to contain a material misstatement caused by error or fraud (Kadous 2000). However, auditors are only required to provide reasonable assurance on the material correctness of the financial statements (AU 230.10; PCAOB 2006). As a result, some audit failures are not necessarily indicative of low audit quality.
of the auditor to take the stand despite the risk of a detrimental cross-examination (Aronica 2006). Thus, auditors stand to benefit from a better understanding of how the documentation decisions that they make during the audit (i.e., *ex ante* decisions) and that are under their complete control affect jurors’ decision making.

I examine two audit documentation decisions related to how auditors gather and evaluate audit evidence. Current auditing standards require auditors to gather evidence using a risk-based audit approach\(^2\) (PCAOB 2010a, b) and then to use their professional judgment when evaluating that audit evidence (AU 230.07; PCAOB 2006). However, auditing standards do not provide specific guidance regarding (1) how auditors should document their risk-based audit approach or (2) the documentation necessary to support a well-reasoned professional judgment about the appropriate accounting treatment. Even though all of the largest audit firms follow the prescribed risk-based audit approach, their documentation of this audit approach varies widely and some forms may be easier for jurors to understand than others.\(^3\) Further, audit firms continue to struggle with creating adequate documentation to support their professional judgments regarding the appropriate accounting treatment (Deloitte 2010). Consequently, audit firms recently implemented judgment frameworks that require the documentation of certain key components of reasonable accounting judgments (e.g., KPMG 2011). We currently do not know the implications of either of these documentation decisions on jurors’ decision making.\(^4\)

\(^{2}\) A risk-based audit approach requires auditors to identify the risks of material misstatement for each significant account (PCAOB 2010a) and then perform audit procedures to address the identified risks (PCAOB 2010b).

\(^{3}\) For example, my review of the Big 4 audit firms’ documentation systems revealed that one firm organizes all of its audit work by financial statement line item. The firm then links the audit work to each specific risk of material misstatement that it addresses. Another firm, however, organizes its audit work by business cycle. This firm documents the risk of material misstatement associated with each cycle and links the audit work to the business cycle rather than to the specific risk of material misstatement.

\(^{4}\) In an experiment examining jurors’ liability assessments of expert auditors under imprecise accounting standards, Grenier et al. (2011) find that jurors do not hold general experts more liable than technical experts when the testimony describes the use of a judgment framework. However, participants in this study did not actually see the actual documentation of the judgment framework. Thus, my study addresses the call for future research examining
examines how auditors’ documentation of their risk-based audit approach and their consideration of the alternative accounting treatments as part of a well-reasoned professional judgment affects jurors’ negligence verdicts and damage awards.

In an auditor negligence trial, jurors must first determine auditor negligence before awarding damages. The Culpable Control Model is a broad model of blame assessment that incorporates concepts from legal and moral philosophy (Alicke 2000). According to this model, observers assess blame based on the accused party’s (e.g., the auditor) personal control over the adverse outcome (e.g., the loss associated with an audit failure). Personal control is determined by the accused party’s intentions, foresight, and causal influence over the adverse outcome (Alicke 2000). This study tests the Culpable Control Model in a contextually rich and complex auditor negligence setting and examines the predictions of this model regarding how audit documentation decisions affect jurors’ perceptions of auditors’ personal control and their consequent evaluations of auditor negligence.

After evaluating auditor negligence, those jurors who find the audit firm negligent must then decide how much to award the plaintiff. However, jurors likely use different factors to determine damage awards than those used to assess negligence (Kadous 2000; Lowe et al. 2002). Prior research suggests that jurors consider both the severity of the plaintiff’s losses and the reprehensibility of the defendant’s conduct leading up to the negligent act when assessing damages (Greene et al. 2001). I hold the plaintiff’s losses associated with the alleged audit failure constant at a high level. Given that professional auditing standards govern auditors’ actions, I argue that jurors’ perceptions of auditors’ compliance with those standards will affect

---

5 Kadous (2000) finds that jurors evaluate auditors as if they do not consider the quality of the audit when the consequences of an audit failure are severe. By holding the plaintiff’s losses constant at a high level, I examine how audit documentation decisions affect jurors’ decision making in cases where prior research suggests that jurors tend to underweight evidence related to the actual audit work performed.
the judged reprehensibility of auditors’ actions leading up to the negligent act. Therefore, this
study examines how audit documentation decisions affect jurors’ perceptions of auditors’
compliance with the professional auditing standards and jurors’ assignment of damages.

I conduct an experiment in which a diverse group of actual jurors called for jury duty
determine an audit firm’s negligence and damages to be awarded in a case involving an
inventory valuation judgment. All participants hear the same testimony about the evidence
auditors collected and the work they performed during the audit; only the documentation of this
evidence in the audit workpapers differs across conditions. I manipulate two documentation
variables between participants. First, I manipulate whether the documentation reflects the risk-
based audit approach taken by the audit firm by varying whether or not the specific risks of
material misstatement are explicitly linked to the audit procedures performed to address each
risk. Second, I manipulate auditors’ documentation of their professional judgment about the
necessity of the writedown of inventory. I manipulate this by either including the facts consistent
with both alternative accounting methods considered (i.e., writing the inventory down to a lower
market value or reporting the inventory at cost) or by including only the facts consistent with the
accounting treatment followed (i.e., reporting the inventory at cost) in the audit workpapers.

I find that jurors perceive the overvaluation of inventory as more foreseeable when
auditors document their consideration of the facts consistent with both the followed and the
alternative accounting treatment. As expected, due to the increased foreseeability of the
overvaluation, jurors are more likely to find auditors negligent when the workpapers capture
their consideration of the alternative accounting treatments. However, consistent with my
expectations, there is a different pattern of results for jurors’ damage awards. I find that jurors
rated auditors’ compliance with the auditing standards the highest and awarded the lowest
damages when the audit documentation reflects the risk-based audit approach and includes auditors’ consideration of the alternative accounting treatments for the specific audit judgment. This is consistent with the argument that jurors perceive auditors’ actions to be less reprehensible when they comply with the auditing standards.

Overall, my study shows that a different set of factors affects jurors’ negligence verdicts and assignment of damages. Consistent with the Culpable Control Model, I find that jurors’ evaluations of auditor negligence are driven by their assessments of auditors’ personal control, as measured by jurors’ perceptions of auditors’ causation, intentions, and foresight. Once jurors find the auditor firm liable, the reprehensibility of auditors’ actions, as measured by their compliance with the auditing standards, affects jurors’ damage awards. Thus, when deciding how best to document their work, auditors should consider the effects of such documentation on both their negligence likelihood and the potential damages associated with a negligence verdict.

My study contributes to the accounting literature in several ways. First, I examine how audit documentation decisions reflected in the audit workpapers affect jurors’ evaluations of auditor negligence and assignment of damage awards. Although audit workpapers capture the evidence to support auditors’ conclusions, no prior studies have examined how the documentation choices made in these workpapers affect jurors’ decision making. Second, my study finds that there is a double-edged sword associated with more complete documentation of auditors’ judgment process. In particular, it is risky for auditors to document their consideration of the alternative accounting treatments because such documentation increases jurors’ perceptions of the foreseeability of the misstatement, resulting in a higher negligence likelihood. However, when this same documentation is combined with documentation of the risk-based audit approach that captures the linkages between the audit risks and work performed to address
each risk, jurors perceive auditors’ actions prior to the negligent act as most compliant with the auditing standards and consequently award the lowest damage awards.

Third, I introduce the Culpable Control Model to the accounting literature to examine the underlying determinants of jurors’ evaluations of auditor negligence. I test this broad model of blame assessment in a contextually rich setting involving a complex auditor negligence case. My findings suggest that this model is descriptive of jurors’ evaluations of auditor negligence, highlighting the importance of auditors’ personal control in jurors’ determination of negligence and providing a framework for future research examining auditor negligence.

Finally, my study adds to the literature by investigating how jurors assign damage awards, which is of interest to practitioners, academics, and regulators concerned about auditors’ litigation costs. As of 2008, the six largest audit firms were defendants in 90 disputes with damage claims in each case exceeding $100 million (The Department of Treasury 2008). However, few auditor negligence cases are tried all the way to verdict because audit firms often feel pressured to settle cases rather than risk having a jury award damages in an amount that could threaten their survival (Oberly 2008). My study demonstrates that although auditors’ documentation of their consideration of the accounting alternatives leads to a higher negligence likelihood, this same documentation when combined with documentation that reflects the risk-based audit approach effectively reduces damage awards to an amount that is comparable to what the audit firm would have been willing to settle for. Thus, my study suggests that audit firms need not settle simply due to fears of detrimental damage awards. Rather, auditors should consider how their documentation decisions affect both their negligence likelihood and any potential damages associated with a negligent verdict before deciding whether to settle or not.

---

6 Audit firms spend 40 times more on litigation-related costs than the average business operating in the United States with such costs accounting for 6.6% of total revenues and 15.1% of audit-related revenues (Deloitte 2010).
CHAPTER 2
THEORY AND HYPOTHESES DEVELOPMENT

Background

Audit workpapers play a key role in every aspect of an auditor negligence trial. Audit Standard (AS) No. 3 governs the compilation of the audit workpapers and requires that these workpapers provide sufficient detail to enable a clear understanding of the purpose of the test performed, the source of the evidence obtained, and the conclusions reached (PCAOB 2004). Lawyers carefully review these workpapers prior to the trial in order to understand how the audit team developed the audit plan and the rationale for the progression of the audit work performed (Snell and Wilmer 2003). During the trial, the audit workpapers are presented to the jury as evidence of the work the auditors did and did not do during the audit (Swanson and Rendon 2004). Experts hired by both the defense and plaintiff attorneys provide their perspectives regarding the strengths and weaknesses of the audit based on these audit workpapers, yet these experts tend to cancel each other out (Snell and Wilmer 2003). The exhibits entered into evidence during the trial are then made available to the jurors during the deliberation process (ABA 2005). Therefore, before jurors make any decisions, they are able to review the audit workpapers in the jury room to obtain a better understanding of the audit work supporting auditors’ judgments and conclusions. Given the important role of audit workpapers, this study

---

7 For example, in Travelers Casualty and Surety Co. v. Ernst & Young, 542 F.3d 475 (5th Cir., 2008), Travelers sued Ernst & Young for negligence in auditing alleging that Ernst & Young allowed Friede Goldman Halter, Inc. to grossly underestimate the losses at risk associated with a special project that Travelers was financing. During the trial, the audit workpapers detailing the audit of the potential losses from this special project were presented to the jury. The plaintiff’s expert witness highlighted the holes in Ernst & Young’s documentation of their assessment of the reasonableness of the estimate during his testimony. The jury awarded Travelers $14.4 million and this decision was affirmed upon appeal.
examines how audit documentation decisions affect jurors’ evaluations of auditor negligence and assignment of damage awards.

**Jurors’ Evaluations of Auditor Negligence**

I adapt the Culpable Control Model (Alicke 2000) to a complex auditor negligence trial to predict how the evidence presented during a trial affects jurors’ evaluations of auditor negligence. The Culpable Control Model depicted in Figure 1 is a broad model of blame attribution that has never been tested in a contextually rich setting involving a complex auditor negligence trial.8

Starting at the bottom of the model, the Culpable Control Model predicts that jurors’ spontaneous reactions to the *case* can directly influence their evaluations of auditor negligence. Lagnado and Channon (2008) explain that this direct influence occurs when an observer attributes blame to the actor due to their overall feelings about the case or event. Prior auditing studies have focused on this direct reaction to the case and find that jurors evaluate auditors as if they did not consider audit quality when the consequences of the audit failure are severe (Kadous 2000). This is because severe negative outcome information creates negative affect which jurors use as a cue to auditor blameworthiness during their evaluation process (Kadous 2001). In this study, I hold the severity of the outcome constant at a high level in order to investigate how auditors’ documentation decisions affect jurors’ decision making in a setting where we know they are heavily influenced by their affective reactions to the outcome of the case.

Moving to the top of the model, jurors’ spontaneous reactions to the *auditors* can indirectly influence their evaluations of auditor negligence. Alicke (2000) explains that these indirect spontaneous reactions stem from observers’ spontaneous reactions to the favorability or

---

8 Alicke (2000) developed the Culpable Control Model to provide a comprehensive model of the process by which blame and mitigation occurs. Although the model incorporates concepts from legal and moral philosophy, the Culpable Control Model is ultimately geared to explain everyday conduct evaluation.
unfavorability of the accused party. In an auditor negligence setting, jurors likely have prior beliefs that influence their feelings about the auditors. As such, their reaction to the auditors is capturing more than the manipulations examined in this study and is not the focus of my study.

The last factor that the model describes as influencing jurors’ evaluations of auditor negligence is jurors’ assessments of auditors’ personal control. The model hypothesizes that observers lay blame based on their assessment of the accused party’s personal control over the adverse outcome (Alicke 2000). The criteria used to assess personal control include evaluating auditors’ causal influence over the harmful outcome, as well as determining auditors’ intentions underlying their behavior and the foreseeability of the misstatement. Negligence trials in most states hinge on whether jurors believe that auditors exercised reasonable care and were competent as defined by what other audit professionals would have done in the same situation (Causey and Causey 1991). Thus, when determining auditors’ personal control, auditors’ causal influence over the harmful outcome, auditors’ intentions underlying their behavior, and the foreseeability of the misstatement are determined by comparison to what other auditors would have done. Despite the suggested importance of auditors’ personal control to jurors’ evaluations of auditor negligence, it has been largely ignored by prior auditing research. Therefore, my study specifically investigates how auditors’ documentation decisions affect the determinants of jurors’ assessments of auditors’ personal control that, in turn, affect jurors’ evaluations of auditor negligence.

---

9 Most litigation against auditors alleges negligence rather than fraud (Causey and Causey 1991; Grubbs and Ethridge 2007). In order to prove fraud, the plaintiff must prove that auditors intended to deceive, manipulate, or defraud users of the financial statements. Unlike fraud, negligence only requires that the plaintiff prove that the auditor had a duty, the auditor breached that duty, the plaintiff suffered a loss, and the auditor’s breach of duty was the proximate cause of the plaintiff’s loss (Causey and Causey 1991).
*Auditors’ Causal Control over the Misstatement*

The Culpable Control Model suggests that jurors consider auditors’ causal control (one element of personal control) over the misstatement when evaluating auditor negligence. One defense strategy used in auditor negligence trials attempts to reduce jurors’ perceptions of auditors’ causal control over the adverse outcome by arguing that the accounting for the transaction in question complied with generally accepted accounting principles. However, auditors are concerned that jurors will not respect their professional judgments regarding the most appropriate accounting treatment under less precise accounting standards (PCAOB 2008). Kadous and Mercer (2012) investigate this concern and find that jury verdicts are driven by the consistency of the client reporting choice with the accounting standards when the standards are precise, but verdicts are driven by the consistency with the industry norms when standards are imprecise. This suggests that jurors perceive auditors as having less causal control over the audit failure when the accounting is consistent with what is perceived as “normal”. In this study, I hold the precision of the accounting standards constant and I do not expect auditors’ documentation of their work to affect jurors’ assessments of auditors’ causal control in this study.

*Auditors’ Intentions to Conduct a Quality Audit*

I do, however, expect that the way in which auditors document their audit approach will affect jurors’ perceptions of auditors’ intentions to conduct a quality audit. Legal standards dictate that jurors evaluate auditors based on their actions (Causey and Causey 1991), yet auditors’ actions are governed by the auditing standards. These standards require auditors to provide reasonable (as opposed to absolute) assurance that the financial statements are not materially misstated (AU 230.10; PCAOB 2006). To provide this reasonable assurance, the auditing standards instruct auditors to take a risk-based audit approach. This type of audit
approach requires auditors to identify the risks of material misstatement for each significant account (PCAOB 2010a) and design an audit that properly addresses those risks (PCAOB 2010b). As mentioned earlier, jurors evaluating auditors in a negligence trial are asked to compare the work performed during the audit to what other auditors would have done (Kadous 2000). Thus, jurors’ must determine whether auditors intended to conduct a risk-based audit and behave as other audit professionals would have in the same situation.

Given that jurors likely lack audit experience (Zeisel and Diamond 1976; Fulero and Penrod 1990), the audit workpapers are key to helping jurors understand the audit approach taken. However, auditing standards do not provide specific guidance on how auditors should document their risk-based approach. Consequently, even though all firms use a risk-based audit approach, documentation of this audit approach varies greatly between audit firms. Such documentation differences likely affect jurors’ understanding of what audit work was performed to address each identified risk. For instance, documentation that explicitly links each risk of material misstatement to the related audit work clearly tells the story of a risk-based audit. However, when the same identified risks and related audit work are not explicitly linked in the audit documentation, jurors are less likely to understand how the audit firm addressed each risk.

Jurors’ perceptions of auditors’ intentions to conduct a quality risk-based audit are likely affected by the ease with which jurors can understand how auditors addressed each identified risk of material misstatement. Although I expect it is easier to understand the risk-based audit approach when the audit work performed is explicitly linked to the specific risks of material

---

10 My review of each of the Big 4 audit firms’ documentation systems revealed that each firm differs in its documentation of this risk-based approach. For example, one firm explicitly links the risks of material misstatement to the related audit work. In contrast, another firm documents the risks of material misstatement in separate location from the audit work designed to address each risk. The documentation of the audit approach at the two remaining audit firms falls in between these firms.
misstatement it addresses, there is the risk that such documentation will make it easier for jurors to think of what the auditors could have done differently to detect the misstatement. Such counterfactual thoughts have been shown to induce negative affect in jurors, which negatively biases jurors’ evaluations of auditors (Reffett 2010). However, individuals are less likely to engage in such counterfactual reasoning for events that they perceive as uncontrollable (e.g., Girotto et al. 1991; Markman et al. 1995). In the auditing context, the standards (as opposed to the audit firm) control the type of audit approach taken. Auditors must conduct a risk-based audit to provide the required reasonable assurance. Therefore, I do not expect that auditors’ documentation of the uncontrollable risk-based audit approach will affect jurors’ use of counterfactual reasoning. Rather, I expect that explicitly linking the identified risks with the specific audit work to address each of those risks will improve jurors’ perceptions of auditors’ intentions to conduct a quality risk-based audit, a key determinant of auditors’ personal control. Stated formally, I hypothesize the following:

\[ H1: \text{Jurors' evaluations of auditor intentions to conduct a quality audit will be more positive when the audit workpapers explicitly link the identified risks to the specific audit work performed to address each risk than when they do not.} \]

**Foreseeability of the Misstatement**

I also expect that auditors’ documentation of their consideration of alternative accounting treatments will affect jurors’ perceptions of the foreseeability of the misstatement at the time of the audit. Because auditors are required to exercise the usual judgment, care, skill, and diligence employed by other auditors (AU 230.05; PCAOB 2006), jurors must determine whether or not other audit professionals would have foreseen the misstatement given the facts available at the time of the audit. However, the facts at the time of the audit are not always easy to interpret and jurors’ evaluations of those facts are made in hindsight. The difficulty with hindsight judgments
is that knowledge of an event outcome causes *ex post* observers to overstate the probability with which they would have been able to predict that outcome before it occurred (Fischhoff 1975). Thus, it is essential that jurors understand how auditors arrived at their decision given the facts available at the time of the audit.

Recognizing the importance of auditors’ professional judgments, audit firms have recently developed and implemented judgment frameworks (Deloitte 2009; KPMG 2011). These judgment frameworks are based on the Security and Exchange Commission’s Advisory Committee on Improvements to Financial Reporting’s proposed judgment guidance that highlights the important components of reasonable accounting judgments (CIFiR 2008).\(^\text{11}\) The goal of these frameworks is to encourage auditors to follow and document a disciplined judgment process. The components common to all of the frameworks include the identification of the issue, gathering of all of the relevant facts, consideration of the relevant guidance, evaluation of the reasonable alternatives, and rationale for the final decision (Deloitte 2009; KPMG 2011). Arguably, the most contentious component of these frameworks is auditors’ documentation of their evaluation of the reasonable alternatives. Given auditors’ tendency to minimize audit documentation that may leave an incriminating audit trail (Levy 2005), auditors are likely to be reluctant to include such documentation in their audit workpapers unless they are confident that it will not be used against them during a trial. Therefore, when documenting their professional judgments, auditors must decide whether to include only their consideration of the facts that support the accounting treatment followed or to also acknowledge their consideration of the contrary facts that support the alternative accounting treatment in their workpapers.

\(^{11}\) The Advisory Committee on Improvements to Financial Reporting identifies 11 key components to a reasonable accounting judgment, including the analysis of alternative views or estimates (CIFiR 2008).
Social psychology research suggests that audit firms stand to benefit from the documentation of their consideration of the alternative accounting treatments. Although such documentation requires jurors to actively integrate inconsistent facts, jurors are likely to perceive auditors as less biased when their documentation captures both sides of the issue. This is important because the effectiveness of a communication increases as the perceived bias of the communication source decreases (Birnbaum and Stegner 1979) and an unbiased source of evidence is more persuasive than a biased source (Reinard 1988). Further, jurors are less likely to rule against an audit firm with a more persuasive defense (Buckless and Peace 1993). Thus, auditors may benefit from documenting their consideration of the alternative accounting treatments.

Cognitive psychology and legal research, in contrast, supports auditors’ concerns and suggests that auditors may be better off only documenting their consideration of the facts consistent with the accounting treatment followed. Horowitz and Bordens (2002) examine jurors’ recall of evidence from complex expert testimony and find that jurors tend to recall evidence that supports the plaintiff’s claim (i.e., the facts that contradict the accounting treatment followed). Further, individuals presented with technically complex evidence for which they have no expertise default to heuristic modes of processing (Chaiken et al. 1989). This is important because jurors with any expertise related to the issues in a civil case are generally eliminated from the jury pool (Zeisel and Diamond 1976; Fulero and Penrod 1990). One common form of heuristic processing is to assess the likelihood of an event based on the ease with which facts supporting its occurrence are brought to mind (Tversky and Khaneman 1973). Taken together, the above findings suggest that auditors’ documentation of their consideration of the accounting alternatives may increase the salience of the facts that contradict the accounting treatment.
followed, making it easier for jurors to recall facts that support the plaintiff’s claim that the audit firm made the wrong decision. This in turn would lead jurors to perceive the misstatement as more foreseeable and auditors’ judgments as less reasonable. Consequently, I hypothesize the following:

\[ H2: \text{Jurors will perceive the misstatement as more foreseeable when the workpapers include auditors’ consideration of the alternative accounting treatments than when they only include the facts that support the accounting treatment followed.} \]

**Auditor Negligence**

Although I expect audit documentation decisions to influence jurors’ perceptions of auditors’ intentions and the foreseeability of the misstatement, auditors are concerned with jurors’ evaluations of their negligence. Based on the Culpable Control Model, I expect that jurors’ evaluations of auditor negligence will increase with their perceptions of the determinants of auditors’ personal control. The required risk-based audit approach is designed to provide the required reasonable assurance that the financial statements are free of material misstatements. Consequently, jurors will likely perceive auditors as having less personal control over the failure to find a material misstatement when they believe that auditors had good intentions to conduct a quality risk-based audit. Therefore, I expect that jurors’ evaluations of auditor negligence will be lower when the identified risks are explicitly linked to the specific audit work performed to address each risk in the audit workpapers than when they are not. However, I expect that jurors’ perceptions of auditors’ personal control will increase with jurors’ perceptions of the foreseeability of the misstatement. Consequently, I expect that jurors’ evaluations of auditor negligence will be higher when the workpapers capture auditors’ consideration of the alternatives than when they do not. I formally hypothesize the following:
**H3:** Jurors’ evaluations of auditor negligence will be lower when the audit workpapers explicitly link the identified risks and the specific audit work performed to address each risk than when they do not.

**H4:** Jurors’ evaluations of auditor negligence will be higher when the workpapers include auditors’ consideration of the alternative accounting treatments than when they only include the facts that support the accounting treatment followed.

**Jurors’ Assessment of Damage Awards**

Once a negligence liability determination is made, jurors face the difficult task of determining the appropriate amount of damages to award the plaintiff. While the determinants of auditors’ personal control are hypothesized to affect jurors’ evaluations of auditor negligence, the factors that influence damage awards do not necessarily overlap with the factors that influence jurors’ determination of negligence (Kadous 2000).\(^{12}\) Liability and damages are separate issues that are each informed by a unique set of evidence (Greene et al. 2001).

In theory, after finding the defendant liable for negligence, jurors are to switch their efforts from evaluating the defendant’s actions to providing restitution for the harm suffered by the plaintiff. However, consistent with prior research (e.g., Chapman and Bornstein 1996; Feigenson et al. 1997), Greene et al. (2001) find that evidence related to the carelessness of the defendant’s conduct leading up to the negligent act affects both the frequency and size of damages awarded to the plaintiff in an automobile negligence case. Thus, jurors take into consideration the reprehensibility of the defendant's behavior, in addition to the severity of the plaintiff’s injuries when assessing damages (Cather et al. 1996).

In this study, I hold the severity of the plaintiff’s losses constant at a high level, but it is up to the jurors to assess the reprehensibility of auditors’ actions leading up to the negligent

\(^{12}\) Other factors may influence damage awards even if they do not influence evaluations of negligence. For example, Lowe et al. (2002) finds that the size of the audit firm affects jurors’ damage awards, with jurors being more likely to assess damages against large audit firms.
When evaluating the reprehensibility of auditors’ actions leading up to the negligence act, jurors must consider how auditors gathered and evaluated the audit evidence. I expect that it will be easier for jurors to see how the audit firm gathered the appropriate audit evidence using a risk-based audit approach when the workpapers explicitly link the identified risks of material misstatement and the specific audit work to address each risk. As for the evaluation of that audit evidence, individuals providing arguments and information on all sides of an issue demonstrate expertise and open-mindedness which provides the basis for rational beliefs (Allen 1991). This enhances the credibility of the source (e.g., Kamins 1989; Settle and Golden 1974) and strengthens the persuasiveness of the message (Allen 1991). Thus, I expect that auditors’ documentation of their consideration of the alternative accounting treatments provides evidence of auditors’ efforts to evaluate all of the facts available at the time of the audit. However, auditors’ evaluation of the audit evidence is only relevant if jurors believe that the evidence in question was appropriately gathered following the prescribed risk-based audit approach. As such, I expect that jurors will perceive auditors’ behavior as least reprehensible (i.e., most compliant with the auditing standards) when the audit workpapers explicitly link the identified risks and the

---

13 Jurors evaluate auditors as if they did not consider audit quality when the consequences of an audit failure are severe (Kadous 2000). Because I am interested in identifying how auditors’ documentation decisions affect jurors’ decision making, I need to examine jurors’ decision making in a setting where prior research has found that their decisions are heavily influenced by their affective reactions to the outcome. Therefore, I include severe negative consequences of the audit failure in my case materials in all conditions.
specific audit work to address each risk and include auditors’ consideration of the alternative
accounting treatments. This leads to the following hypothesis:

$$H5: \text{Jurors’ damage awards will be lowest when the audit workpapers explicitly link the}
\text{identified risks to the specific audit work performed to address each risk and include}
\text{auditors’ consideration of the alternative accounting treatments.}$$
This figure illustrates my proposed model of the factors affecting jurors’ evaluations of auditor negligence.

*Indirect Spontaneous Reaction* refers to participants’ impression of the audit firm.  
*Direct Spontaneous Reaction* refers to participants’ affective reactions to the case. Positive (negative) numbers are indicative of affective reactions that are favorable to the auditor (plaintiff).  
*Causation* refers to participants’ assessments of the audit firm’s causal control over the adverse outcome stemming from the misstated financial statements.  
*Intention* refers to participants’ assessments of the audit firm’s intentions to conduct a quality risk-based audit.  
*Foreseeability* refers to participants’ assessments of the foreseeableness of the misstatement given the facts available at the time of the audit.  
*Jurors’ evaluations of auditor negligence* refers to the factor score calculated from participants’ assessment of the audit firm’s blameworthiness and negligence.

**Figure 1**  
Model of Jurors’ Evaluations of Auditor Negligence  
(adapted from Alicke 2000)
CHAPTER 3
EXPERIMENTAL DESIGN AND METHOD

Participants

I test my hypotheses by manipulating how auditors document their audit approach and their professional judgment in a 2 x 2 factorial design. I recruited individuals called for jury duty in a state trial in seven different circuit courts on seven different days from August to October 2011.\textsuperscript{14, 15} With the permission of the presiding judge, the jurors completed the experimental instrument while they were waiting to be questioned by the attorneys or after they were released from jury duty that day.

Materials and Experimental Procedure

The participants were instructed to regard themselves as members of the jury hearing an auditor negligence case. The full case materials are presented in Appendix B. In the first part of the experiment, participants listened to a 28 minute audio recording of a negligence lawsuit that an audit client’s creditor filed against the audit firm. The participants also received a written transcript of the trial and copies of the audit workpapers entered into evidence during the trial.\textsuperscript{16} The trial consisted of the plaintiff’s complaint, the respondent’s answer, both attorneys’ opening statements, the plaintiff’s accounting/auditing witness testimony and cross-examination, testimony from the plaintiff’s damages expert, the defense’s accounting/auditing witness

\textsuperscript{14} Auditor negligence cases can be tried in either state or federal court. The same individuals are eligible to serve on a jury in both the state and federal courts. The only difference is that the federal courts call individuals from larger geographic areas, while the more numerous state courts call individuals from smaller geographic areas.

\textsuperscript{15} Location does not have a significant effect on any of the dependent variables. Therefore, it is not included in the analyses provided in the next section.

\textsuperscript{16} Any audit workpapers that are entered into evidence would be presented to the jury during the trial. Therefore, I included the audit workpapers within the trial transcript to enhance external validity.
testimony and cross-examination, testimony from the defense’s damages expert, both attorneys’ closing statements, and the judge’s instructions to the jury.17

I adapted my litigation case materials from Kadous (2001) and Cohen et al. (2005). Cohen et al. (2005) piloted their case study of a lower-of-cost-or-market inventory valuation decision for a company in the data networking industry with 72 practicing audit managers and partners. After evaluating the facts presented in the case study, 39 audit managers and partners stated that the inventory should be presented at cost and 33 indicated that a write-down was necessary. As such, there was no “correct” valuation decision at the time of the audit. For my case materials, I adapted the materials for the no attribution and severe negative outcome group reported in Kadous (2001) by changing the audit client to a data networking company with slow-turning inventory operating in a very competitive industry and using the facts piloted in Cohen et al. (2005) regarding the lower-of-cost-or-market inventory valuation decision.

In my case, a lender who experienced substantial losses when the audit client declared bankruptcy alleges that the audit firm was negligent in its audit of the valuation of the inventory account. It is important to note that all participants heard the same testimony and were exposed to all of the same facts; only the audit workpapers entered into evidence differed. After the opening statements, the plaintiff’s accounting/auditing expert witness testifies that the audit firm did not use good professional judgment when allowing the inventory to be reported at cost rather than a lower market value. The defense’s accounting/auditing expert enters the actual audit workpapers into evidence and testifies that the audit firm’s conclusion to allow the inventory to be reported at cost was reasonable. Both expert witnesses acknowledge during cross-examination that the facts available at the time of the audit were ambiguous. Damages expert witnesses on

17 A judge who has experience hearing professional negligence cases reviewed my experimental materials to ensure that I included all of the important structural elements, followed the natural order of the testimony, and provided appropriate jury instructions for a negligence trial.
both sides present their assessment of the damages suffered by the plaintiff due to reliance on the misstated financial statements. The closing statements follow and the trial ends with all participants receiving the same instructions from the judge regarding their decision.

Participants then put away the trial transcript and moved to the second phase of the experiment. All participants received a booklet that contained the plaintiff’s complaint, the respondent’s answer, the judge’s instructions, and the exhibits entered into evidence. During this verdict decision phase, the participants decided whether the audit firm was negligent and awarded damages only if they found the audit firm negligent. The final part of the experiment asked participants to answer general questions about the trial, demographic questions, and manipulation checks. Each participant received $10 for their participation in this study.

**Independent Variables**

I manipulated the documentation of the risk-based audit approach at two levels, *reflects risk-based audit approach* and *does not reflect risk-based audit approach*. In both conditions, the audit firm followed a risk-based audit approach. The identified risks of material misstatement and the audit work performed to address those risks were discussed during the testimony heard by all participants. Only the organization of the audit work as captured in the documentation of the audit approach differed across conditions. In the *reflects risk-based audit approach* condition, the audit work performed to address a specific risk of material misstatement was listed directly below that risk, linking the audit work performed to the it risk addressed. In the *does not reflect risk-based audit approach* condition, all of the audit work performed on the inventory account was simply listed below the risks of material misstatement. There was no explicit

---

18 In an effort to facilitate effective and impartial deliberations, the American Bar Association requires that exhibits admitted into evidence be provided to the jury for use during deliberations (ABA 2005).
linkage of the identified risks to the audit work performed to specifically address each of those risks. Examples of both manipulations are included in Appendix C.

I also manipulated the documentation of auditors’ consideration of the alternative accounting treatments at two levels, *alternatives presented* and *no alternatives presented*. All of the facts suggesting the need to write inventory down to a lower market value were conveyed to all participants during the plaintiff’s expert witness testimony, while the defense’s expert witness highlighted the facts supporting the reasonableness of reporting inventory at cost. Only the documentation of auditors’ consideration of the alternatives differed across conditions. In the *alternatives presented* condition, the workpaper supporting the lower-of-cost-or-market decision contained a judgment framework that captures auditors’ consideration of the facts consistent with the alternative accounting treatments (i.e., reporting inventory at cost or writing inventory down to a lower market value). To control for any order or placement effects, half of the participants in this condition saw the facts consistent (inconsistent) with reporting inventory at cost on the left (right).

Participants in the *no alternatives* condition reviewed a judgment framework in the audit workpapers that did not include the facts consistent with writing the inventory down to a lower market value. Examples of each of these manipulations are included in Appendix D.

**Dependent Variables**

Modeling jurors’ assessment of auditor negligence requires capturing several dependent variables. Jurors provided their assessment of whether the audit firm *intended* to conduct a quality risk-based audit (0 = Not at all intended, 10 = Completely intended), the *foreseeability* of the misstatement (0 = Not at all foreseeable, 10 = Completely foreseeable), and the extent to which the audit firm *caused* the plaintiff’s loss (0 = Not at all the cause, 10 = Completely the

---

19 Order does not have a significant effect on any of the dependent variables. Therefore, it is not included in the analyses provided below (p > 0.912).
cause). I then used confirmatory factor analysis on these data to develop my measure of jurors’ perceptions of auditors’ personal control. I also captured jurors’ assessment of how much blame the audit firm deserved for the plaintiff’s loss (0 = None of the blame, 10 = All of the blame). As a direct measure of auditor negligence, jurors provided their evaluations of the likelihood that the audit firm was negligent (0 = Not at all likely, 10 = Extremely likely) and their binary negligence verdict decisions.

As for damages, my theory suggests that jurors assign damage awards based on different factors than those used to assess negligence. To measure the reprehensibility of auditors’ actions, I asked jurors to rate the audit firm’s compliance with (1) the auditing standards that require a risk-based audit approach, and (2) the auditing standards that require auditors to evaluate all of the audit evidence (0 = No compliance, 10 = Full compliance). During the trial, the plaintiff’s damages expert estimated the plaintiff lost $13 million, but the defense’s expert estimated the plaintiff’s losses as no more than $3 million. Therefore, those jurors who decided that the audit firm was negligent indicated the amount of damages they would require the auditors to pay to the plaintiff on a scale from $0 to $13 million.
CHAPTER 4
RESULTS

Descriptive Statistics

A total of 112 jurors volunteered to participate in my study and they took an average of 42 minutes to complete the task. Jurors with any expertise related to the issues in a civil case are generally eliminated from the jury pool (Zeisel and Diamond 1976; Fulero and Penrod 1990). As such, I excluded five participants who were CPAs and one additional participant who was an auditor. Understanding the cause of the misstatement is imperative because the evidence presented during the trial is specifically related to auditors’ judgments around the valuation of the inventory. To verify that the jurors understood the accounting issue that led to the misstatement in the financial statements, I asked the jurors to identify the cause of the misstatement. I excluded nine participants who did not understand that the valuation, not the quantity, of the inventory was incorrect. Finally, I excluded five participants who did not complete the experiment, leaving 92 jurors in my final sample of which 50 are female. These jurors range in age from 21 to 73 years old, with the average age being 48 years old. In addition, 70 of the 92 jurors have at least some college education.

Test of Jurors’ Evaluations of Auditor Negligence

Recall from Section II that the Culpable Control Model proposes that certain factors mediate the relationship between audit documentation decisions and jurors’ negligence assessments. However, this model has never been tested in a contextually rich and complex auditor negligence setting. I use a structural equation model to test if this model adequately
describes jurors’ evaluations of auditor negligence. Although the Culpable Control Model, specifically speaks to assessment of blame, jurors’ probability assessments of auditor negligence are also of interest in this setting. Confirmatory factor analysis confirms that blameworthiness and negligence likelihood load on a single factor (eigenvalue = 1.823, Cronbach’s alpha = 0.903). Therefore, I measure jurors’ evaluations of auditor negligence in the structural equation model using the factor score from this confirmatory factor analysis.

The Culpable Control model suggests that jurors’ perceptions of auditors’ personal control over the adverse outcome, jurors’ indirect spontaneous reactions to auditors, and jurors’ direct spontaneous reactions to the case influence jurors’ evaluations of auditor negligence. I use jurors’ perceptions of auditors’ causation, intentions, and foresight to develop my measure of auditors’ personal control. I measure jurors’ indirect spontaneous reactions to auditors by asking them to rate the favorability of the audit firm’s work based on the facts presented in the case (0 = Very unfavorable, 10 = Very favorable). I also ask jurors to indicate the direction and strength of their feelings toward (1) the audit firm and (2) the plaintiff (0 = Very negative, 10 = Very positive). Consistent with Reffett (2010), I then subtract their feelings toward the plaintiff from their feelings toward the audit firm to create an overall measure of jurors’ direct spontaneous reactions to the case (-10 = Very pro-plaintiff, 10 = Very pro-defendant).

A likelihood ratio Chi-square test indicates the model-implied covariance matrix does not differ from the observed covariance matrix ($\chi^2 = 5.91, p = 0.206$), indicating a good fit. The Tucker-Lewis Index is 0.97 and the incremental fit index is 0.99, both of which are above the standard cutoff value for an acceptable fit of 0.90 (Kline 1998). Thus, the model describes the

---

20 I examine jurors’ probability assessments of auditor negligence, as opposed to participants’ yes/no decisions of auditor negligence. Structural equation models generally use continuous variables as opposed to binary categorical variables, as continuous variables are less likely than categorical variables to violate normality assumptions within structural equation models (Kline 1998).
relationships in the data well and suggests that the Culpable Control Model is descriptive of jurors’ evaluations of auditor negligence.

Figure 2 presents the results of the structural equation model. Consistent with my theory, auditors’ causal control (one-tailed \( p = 0.000 \)), their intentions to conduct a quality audit (one-tailed \( p = 0.026 \)), and foreseeability of the misstatement (one-tailed \( p = 0.000 \)) are significant determinants of auditors’ personal control. Jurors’ assessments of auditors’ personal control drive their evaluations of auditor negligence (one-tailed \( p = 0.008 \)). Although not the focus of my study, there is some evidence that jurors’ affective reactions to the auditors indirectly influence jurors’ perceptions of the determinants of auditors’ personal control (all one-tailed \( p \leq 0.073 \)). However, as seen in Figure 2, jurors’ affective reactions to the case do not directly influence their evaluations of auditors (one-tailed \( p = 0.190 \)). One explanation for this is that I hold the severity of the plaintiff’s losses constant at a high level, creating little variability in this measure. Thus, the test of the model supports the importance of considering jurors’ perceptions of auditors’ personal control during an auditor negligence trial.

Test of H1 and H2

In H1, I predict that the way in which auditors document their risk-based audit approach affects jurors’ assessments of auditors’ intentions to conduct a quality audit. To test H1, I compare jurors’ assessments of auditors’ intentions when the audit workpapers reflect the risk-

21 The Culpable Control Model suggests that auditors’ causal control is a key determinant of their personal control, but I do not expect jurors’ perceptions of auditors’ causal control to be affected by my manipulated variables. Untabulated results of an ANOVA model reveal no significant main or interaction effects (\( p \geq 0.506 \)) for auditors’ documentation of their risk-based audit approach or their consideration of the alternative accounting treatments on jurors’ perceptions of auditors’ causal control.

22 A persistent finding in the auditing literature is that jurors judge auditors more harshly when they are aware of the adverse outcome stemming from misstated financial statements than when they are not (e.g., Kadous 2000, 2001; Clarkson et al. 2002; Becker et al. 2009). It is important to note, though, that these prior studies investigate a negligence case involving management fraud. There remains an expectation gap between what investors believe auditors’ responsibility should be in detecting financial statement fraud and the responsibility that auditors are willing to assume (Hogan et al. 2008). Unlike these prior studies, I examine a case involving auditors’ valuation judgments for which there is no documented expectations gap.
based audit approach (mean = 7.34) to when the workpapers do not reflect this approach (mean = 7.21). In both conditions, jurors generally believed that auditors intended to conduct a quality audit (mean = 7.34 vs. 5, t = 5.88, two-tailed p = 0.000; mean = 7.21 vs. 5, t = 5.77, two-tailed p = 0.000). However, the difference between these two conditions is not significant (t = 0.22, one-tailed p = 0.413). Therefore, H1 is not supported.

As part of the post-experimental questionnaire, jurors rated how easy it was to understand what audit procedures were performed to address each risk (0 = Very Easy, 10 = Very hard). Jurors found it marginally easier to understand the risk-based audit approach when the audit workpapers explicitly capture the linkages between the identified risks and the audit work performed to address each risk (mean = 4.72) than when they do not (mean = 5.50; t = 1.35, one-tailed p = 0.091). Thus, there is some evidence that consistent with my theory, explicit linkages between the risks and audit work improved jurors’ understanding of how the audit firm followed the prescribed risk-based audit approach.23

H2 predicts that whether or not auditors document their consideration of the alternative accounting treatments affects jurors’ assessments of the foreseeability of the misstatement. To test H2, I compare jurors’ assessments of the foreseeability of the misstatement when the workpapers include auditors’ consideration of the alternative accounting treatments to when auditors only include their consideration of the facts consistent with the accounting treatment followed. Jurors assess the misstatement as significantly more foreseeable when auditors document their consideration of the alternatives (mean = 6.31) than when they do not (mean = 5.43; t = 1.78, one-tailed p = 0.040); this supports H2.

23 Consistent with my theory that auditors’ documentation of their risk-based audit approach will not affect jurors use of counterfactual reasoning due to the uncontrollability of the audit approach, untabulated results of an ANOVA model reveal that auditors’ documentation of their risk-based audit approach does not affect how seriously jurors thought about what the audit firm could have done differently to detect the misstatement.
My theory predicts that jurors will view auditors’ judgments as less reasonable when the documentation increases the salience of the contradictory facts. As part of the post-experimental questionnaire, jurors rated how reasonable it was for the audit firm to allow the inventory to be reported at cost (0 = Not at all reasonable, 10 = Completely reasonable). Consistent with my theory, jurors deemed auditors’ inventory valuation judgment as more reasonable when auditors only include the facts that support the accounting treatment followed (mean = 6.09) than when they include their consideration of the accounting alternatives (mean = 4.98; t = 1.84, one-tailed p = 0.035).

Test of H3 and H4

H3 and H4 predict that jurors’ evaluations of auditor negligence will be lower when the workpapers explicitly link the identified risks and the specific audit work performed to address each risk than when they do not (H3), but will be higher when the workpapers include auditors’ consideration of the accounting alternatives than when they do not (H4). I measure jurors’ evaluations of auditor negligence by asking jurors to (1) assess the likelihood that the audit firm was negligent and (2) cast their vote regarding the verdict. The two measures are highly correlated (r = 0.823, two-tailed p = 0.000).

Auditor Negligence Likelihood

I estimate an ANOVA model for jurors’ negligence likelihood assessment. Panel A of Table 1 contains the ANOVA table, Panel B contains the means for the negligence likelihood dependent variable, and Panel C contains the planned contrasts. I find a significant main effect for auditors’ documentation of their consideration of the alternative accounting treatments (F = 4.71, two-tailed p = 0.033), but an insignificant main effect for auditors’ documentation of their risk-based audit approach (F = 0.06, two-tailed p = 0.811) and interaction (F = 0.10, two-tailed p
Therefore, consistent with the lack of support for H1, H3 is not supported since jurors’ evaluations of auditor negligence are not significantly lower when the audit workpapers reflect the risk-based audit approach (mean = 4.56) than when they fail to link the identified risks to the specific audit work performed to address each risk (mean = 4.66; F = 0.06, one-tailed p = 0.406). However, jurors assess a significantly higher negligence likelihood when auditors document their consideration of the accounting alternatives (mean = 5.26) relative to when auditors only document their consideration of the facts consistent with the accounting treatment followed (mean = 4.02; F = 4.71, one-tailed p = 0.017). Thus, H4 is supported.

This finding is consistent with my theory that auditors’ documentation of their consideration of the alternatives increases the salience of the facts that contradict the accounting treatment followed, making it easier for jurors to recall the facts that support the plaintiff’s claim and biasing jurors’ assessment of the foreseeability of the misstatement at the time of the audit. The predicted mediating relationship is demonstrated by the following regression results (Baron and Kenny 1986):

1) Auditors’ documentation of their consideration of the facts consistent with the alternatives influences jurors’ assessments of the foreseeableness of the misstatement (b = 0.880, one-tailed p = 0.040),

2) Jurors’ assessments of the foreseeableness of the misstatement influences their evaluations auditors’ negligence likelihood (b = 0.680, one-tailed p = 0.000), and

3) Inclusion of jurors’ assessments of the foreseeableness of the misstatement eliminates the effect of auditors’ documentation of their consideration of the facts consistent with

---

24 The theory used to describe jurors’ decision making process is a theory of blame attribution. Therefore, I also estimate an ANOVA model for jurors’ assessments of auditors’ blameworthiness on an 11-point Likert-type scale with higher values reflecting higher blameworthiness. Consistent with the results for negligence likelihood, untabulated results indicate that jurors’ assessments of auditors’ blameworthiness are affected by auditors’ documentation of their consideration of the accounting alternatives (F = 4.827, two-tailed p = 0.031). Jurors assess a higher blameworthiness when auditors document their consideration of the alternative accounting treatments relative to when auditors only document their consideration of the facts consistent with the accounting treatment followed.
the alternatives (b = 0.665, one-tailed p = 0.079 when the mediator is included versus b = 1.241, two-tailed p = 0.015 when the mediator is not included in the regression).

Thus, consistent with the Culpable Control Model, jurors’ assessments of the foreseeableness of the misstatement mediates the relationship between auditors’ documentation of their consideration of the facts consistent with the alternative accounting treatments and jurors’ assessment of auditors’ negligence.

Auditor Negligence Verdict

Panel A of Table 2 presents the results of the general linear model with a logit link for the verdict decision. Consistent with the findings for negligence likelihood, jurors’ ultimate verdict decisions are affected by auditors’ documentation of their consideration of the alternative accounting treatments ($\chi^2 = 6.09$, two-tailed p = 0.014) but not their documentation of the risk-based audit approach ($\chi^2 = 0.13$, two-tailed p = 0.716). I present the percentage of jurors finding the audit firm negligent in Panel B and the planned contrasts in Panel C of Table 2. Auditors are more likely to be found negligent when they document their consideration of the alternative accounting treatments (mean = 0.57) relative to when auditors only document their consideration of the facts consistent with the accounting treatment followed (mean = 0.31; $\chi^2 = 6.09$, one-tailed p = 0.007). These findings also support H4.

Test of Jurors’ Damage Awards

Once jurors determine that the audit firm is liable, jurors must assign damages. During the trial, the plaintiff’s damages expert argued that the audit firm’s negligence in the conduct of its audit cost the plaintiff $13 million in lost principal and interest on its loan to the audit client. However, the defense’s damages expert argued that the plaintiff only lost the interest it would have earned on the loan, which was valued at a little over $3 million. Those jurors who found the audit firm negligent provided damage awards from $0 to $13 million.
Test of H5

While the above results confirmed that jurors’ evaluations of auditor negligence are driven by their perceptions of auditors’ personal control, the reprehensibility of auditors’ actions is hypothesized to affect jurors’ damage awards. Consistent with prior research (e.g., Reffett 2010), the test of H5 examines the damage awards provided by only those jurors who found the audit firm negligent. H5 predicts that jurors’ damage awards will be lowest when the audit workpapers reflect the risk-based audit approach and include auditors’ consideration of the alternative accounting treatments. Accordingly, I test H5 with a linear contrast of cell means (Buckless and Ravenscroft 1990). I use a contrast weight of -3 when the documentation reflects the risk-based audit approach and includes auditors’ consideration of the alternatives. All other conditions have a contrast weight of +1. An ANOVA model is provided in Panel A of Table 3. I report the mean damage awards in Panel B and use a planned contrast reported in Panel C to test this hypothesis. Consistent with my expectation, jurors award significantly lower damages when auditors’ documentation reflects the risk-based audit approach and they document their consideration of the alternative accounting treatments than in any other condition (F=4.98, one-tailed p=0.016). Therefore, H5 is supported.

Additional Analysis

In an effort to understand the factors affecting these damage awards, I measured jurors’ perceptions of auditors’ compliance with (1) the auditing standards that require auditors to identify the risks of material misstatement and perform audit work to address each identified risk, and (2) the auditing standards that require auditors to evaluate all of the audit evidence before making a professional judgment. I measured these on 11-point Likert-type scales with

---

25 Participants were randomly assigned to one of the four treatment conditions. Only those participants that found the audit firm negligent awarded damages. Thus, the unequal cell sizes for the damage awards are not attributable to subject attrition, but are the results of the original random sample.
higher values reflecting higher compliance with the respective auditing standards (0 = No compliance, 10 = Full compliance). I run a MANOVA model for these two measures and again use contrast weights of -3, +1, +1, +1 to examine jurors’ perceptions of auditors’ compliance with the auditing standards. I find that jurors rate auditors as complying the most with the auditing standards (F = 3.80, one-tailed p = 0.016) when auditors’ documentation reflects the risk-based audit approach and includes their consideration of the alternative accounting treatments. Further, the damage awards in this condition are not significantly different than $3 million, or the amount for which the defense would likely settle (t = 0.519, two-tailed p = 0.614). These results suggest that jurors’ damage awards are influenced by jurors’ perceptions of the reprehensibility of auditors’ actions as measured by their compliance with the auditing standards.
This figure shows the results of the structural equation model. Standardized factor loadings and corresponding p-values (one-tailed) are shown on the links between the personal control construct and causation, intention, and foreseeability. All other numbers are unstandardized path coefficients and corresponding p-values (one-tailed).

Causation refers to participants’ responses to the post-experimental question “Did Smith & Company’s (the audit firm) actions cause Bierhoff, Ltd’s (the plaintiff) loss?” (0 = Not at all the cause, 10 = Completely the cause).

Intention refers to participants’ responses to the post-experimental question “Did Smith & Company (the audit firm) intend to conduct a quality risk-based audit by identifying the risks of material misstatement and performing audit work to specifically address each of those identified risks?” (0 = Not at all intended, 10 = Completely intended).

Foreseeability refers to participants’ responses to the post-experimental question “Was the overstatement of inventory foreseeable given the facts available at the time of the audit?” (0 = Not at all foreseeable, 10 = Completely foreseeable).

Jurors’ evaluations of auditor negligence is a factor score based on participants’ assessments of the likelihood that the audit firm was negligent (0 = Not at all likely and 10 = extremely likely) and participants’ responses to the post-experimental question “How much blame does Smith & Company (the audit firm) deserve for Bierhoff, Ltd’s (the plaintiff) loss?” (0 = None of the blame, 10 = All of the blame).

Indirect Spontaneous Reaction refers to participants’ responses to the post-experimental question “Given what you know about Smith & Company (the audit firm), do you have a favorable or unfavorable impression of the audit firm?” (0 = Very unfavorable, 10 = Very favorable).

Direct Spontaneous Reaction is calculated by subtracting participants’ feelings toward the plaintiff (0 = Very negative, 10 = Very positive) from their feelings towards the audit firm (0 = Very negative, 10 = Very positive) such that -10 = Very pro-plaintiff, 10 = Very pro-defendant.

Figure 2
Test of Model of Jurors’ Evaluations of Auditor Negligence
### Table 1

**Jurors’ Evaluations of Negligence Likelihood**

**Panel A: Two-way ANOVA**

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Approach</td>
<td>1</td>
<td>0.42</td>
<td>0.06</td>
<td>0.811</td>
</tr>
<tr>
<td>Alternatives</td>
<td>1</td>
<td>34.66</td>
<td>4.71</td>
<td>0.033</td>
</tr>
<tr>
<td>Audit Approach * Alternatives</td>
<td>1</td>
<td>0.75</td>
<td>0.10</td>
<td>0.750</td>
</tr>
<tr>
<td>Error</td>
<td>88</td>
<td>7.35</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Panel B: Negligence Likelihood**

Mean (SE) [N] Cell

<table>
<thead>
<tr>
<th></th>
<th>No Alternatives Presented</th>
<th>Alternatives Presented</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does Not Reflect Risk-Based Audit Approach</td>
<td>4.00 (0.532) [26]</td>
<td>5.41 (0.565) [23]</td>
</tr>
<tr>
<td>Reflects Risk-Based Audit Approach</td>
<td>4.05 (0.578) [22]</td>
<td>5.10 (0.592) [21]</td>
</tr>
</tbody>
</table>

**Panel C: Tests of H3 and H4**

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>$F_{1,88}$</th>
<th>one-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>H3: B &lt; A</td>
<td>0.06</td>
<td>0.406</td>
</tr>
<tr>
<td>H4: D &gt; C</td>
<td>4.71</td>
<td>0.017</td>
</tr>
</tbody>
</table>

*Audit approach* is the treatment variable manipulated at two levels (Does not reflect audit approach; Reflects audit approach).

*Alternatives* is the treatment variable manipulated at two levels (No alternatives presented; Alternatives presented).

*Negligence likelihood* is jurors' likelihood assessment of whether the audit firm was negligence on a scale from 0 = Not at all likely to 10 = Extremely likely.
Table 2

Jurors’ Negligence Verdicts

Panel A: General Linear Models (Logit Link, Binomial Distribution) for Juror Verdicts

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>$\chi^2$</th>
<th>two-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Approach</td>
<td>1</td>
<td>0.13</td>
<td>0.716</td>
</tr>
<tr>
<td>Alternatives</td>
<td>1</td>
<td>6.09</td>
<td>0.014</td>
</tr>
<tr>
<td>Audit Approach * Alternatives</td>
<td>1</td>
<td>0.18</td>
<td>0.673</td>
</tr>
</tbody>
</table>

Panel B: % of Jurors Finding Audit Firm Negligent Mean (SE) [N] Cell

<table>
<thead>
<tr>
<th>Audit Approach</th>
<th>No Alternatives Presented</th>
<th>Alternatives Presented</th>
<th>Mean (SE)</th>
<th>[N] Cell</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does Not Reflect Risk-Based Audit Approach</td>
<td>0.35 (0.095) [26]</td>
<td>0.57 (0.106) [23]</td>
<td>0.45 (0.072) [49] A</td>
<td></td>
</tr>
<tr>
<td>Reflects Risk-Based Audit Approach</td>
<td>0.27 (0.097) [22]</td>
<td>0.57 (0.111) [21]</td>
<td>0.42 (0.076) [43] B</td>
<td></td>
</tr>
<tr>
<td></td>
<td>0.31 (0.068) [48]</td>
<td>0.57 (0.076) [44]</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Panel C: Tests of H3 and H4

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>$\chi^2$</th>
<th>one-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>H3: B &lt; A</td>
<td>0.13</td>
<td>0.358</td>
</tr>
<tr>
<td>H4: D &gt; C</td>
<td>6.09</td>
<td>0.007</td>
</tr>
</tbody>
</table>

Audit approach is the treatment variable manipulated at two levels (Does not reflect audit approach; Reflects audit approach).

Alternatives is the treatment variable manipulated at two levels (No alternatives presented; Alternatives presented).

Negligence verdict is jurors' binary verdict decision where 0 = Not negligent and 1 = Negligent.
## Table 3

### Jurors’ Damage Awards

#### Panel A: Two-way ANOVA

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>two-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Approach</td>
<td>1</td>
<td>0.15E+13</td>
<td>0.10</td>
<td>0.752</td>
</tr>
<tr>
<td>Alternatives</td>
<td>1</td>
<td>1.99E+13</td>
<td>1.39</td>
<td>0.247</td>
</tr>
<tr>
<td>Audit Approach * Alternatives</td>
<td>1</td>
<td>6.01E+13</td>
<td>4.20</td>
<td>0.048</td>
</tr>
<tr>
<td>Error</td>
<td>36</td>
<td>1.43E+13</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

#### Panel B: Damage Awards Mean (SE) [N] Cell

<table>
<thead>
<tr>
<th>No Alternatives</th>
<th>Alternatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Presented</td>
<td>Presented</td>
</tr>
<tr>
<td><strong>Does Not Reflect Risk-Based</strong></td>
<td></td>
</tr>
<tr>
<td>Audit Approach</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>B</td>
</tr>
<tr>
<td>5,333,333</td>
<td>6,423,077</td>
</tr>
<tr>
<td>(1,224,745)</td>
<td>(1,007,736)</td>
</tr>
<tr>
<td>[9]</td>
<td>[13]</td>
</tr>
<tr>
<td><strong>Reflects Risk-Based</strong></td>
<td></td>
</tr>
<tr>
<td>Audit Approach</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>D</td>
</tr>
<tr>
<td>7,500,000</td>
<td>3,460,000</td>
</tr>
<tr>
<td>(2,202,272)</td>
<td>(885,879)</td>
</tr>
<tr>
<td>[6]</td>
<td>[12]</td>
</tr>
</tbody>
</table>

#### Panel C: Test of H5

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>F_{1,36}</th>
<th>one-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>H5: D &lt; (A + B + C)/3</td>
<td>4.98</td>
<td>0.016</td>
</tr>
</tbody>
</table>

*Audit approach* is the treatment variable manipulated at two levels (Does not reflect audit approach; Reflects audit approach).
*Alternatives* is the treatment variable manipulated at two levels (No alternatives presented; Alternatives presented).
*Damage award* is jurors' assessment of damages on a scale from $0 to $13 million.
CHAPTER 5

CONCLUSION

Audit workpapers represent a key piece of evidence supporting the quality of auditors’ work (PCAOB 2004), yet little is known about how audit documentation decisions affect jurors’ decision making. My study addresses this void in the literature. Specifically, I examine how auditors’ documentation of their risk-based audit approach and their consideration of the alternative accounting treatments affect jurors’ evaluations of auditor negligence and assignment of damage awards. My experimental design allows me to test a model of jurors’ evaluations of auditor negligence, as well as the underlying factors that affect jurors’ damage awards.

As expected, results show that different factors affect jurors’ negligence verdicts and damage awards. Consistent with the Culpable Control Model, I find that jurors’ evaluations of auditor negligence are driven by their perceptions of auditors’ personal control as measured by auditors’ intentions, causal control, and foresight. While the way in which auditors document their risk-based audit approach does not affect jurors’ evaluations of auditors’ intentions to provide a high quality audit, jurors do perceive the misstatement as more foreseeable when auditors document their consideration of the alternative accounting treatments. Consequently, auditors are more likely to be found negligent when they document their consideration of the alternative accounting treatments relative to when auditors only document their consideration of the facts consistent with the accounting treatment followed, regardless of the documentation of their risk-based audit approach. However, the same documentation of auditors’ consideration of the alternative accounting treatments results in jurors awarding the lowest amount of damages,
but only when the audit workpapers reflect the risk-based audit approach. This is because jurors perceive auditors as best complying with all of the auditing standards in this condition.

My study makes several contributions to research and practice. I contribute to the audit literature by providing evidence that audit documentation decisions influence jurors’ evaluations of auditor negligence, as well as jurors’ damage awards. Specifically, the results highlight a potential unintended consequence of regulators’ call for more complete documentation of auditors’ judgment process in that auditors face a higher negligence likelihood when they document their consideration of the accounting alternatives. However, when combined with documentation that reflects the risk-based audit approach, that same documentation can be beneficial in reducing damage awards. Thus, audit firms need not settle simply due to fears of detrimental damage awards associated with a negligent verdict, but should consider how their documentation decisions affect both their negligence likelihood and any potential damages.

This study also tests and finds support for a model of the underlying determinants of jurors’ evaluations of auditor negligence in complex auditor negligence trials involving auditor judgment. This model highlights the importance of jurors’ perceptions of auditors’ personal control and how auditors’ ex ante documentation decisions affect this key determinant of jurors’ negligence verdicts. Auditors would benefit from future research exploring how the evidence presented at trial via testimony and the subpoenaed workpapers affects jurors’ perceptions of auditors’ personal control. Further, this study provides insight into audit firms’ risk of exposure to detrimental damage awards by identifying auditors’ perceived compliance with the auditing standards as an important underlying determinant of jurors’ damage awards and investigating how audit documentation decisions affect jurors’ damage awards. Additional research is needed
to identify other factors that influence damage awards so that audit firms can be better informed of their risk of loss prior to deciding whether to settle or proceed to trial.

This study is subject to limitations. First, this study examines an auditor negligence case where the misstatement stemmed from auditors’ professional judgment related to the aggressive valuation of the inventory account; there were no accusations of management fraud. As such, this study can only speak to accusations of negligence due to judgmental errors not fraud. However, auditors’ judgments are important given the increased litigation risk associated with fair value accounting (Laux and Leuz 2009). Second, regardless of how auditors documented their risk-based audit approach, jurors rated auditors as having good intentions. Therefore, these results may not generalize to settings where jurors perceive auditors as having poor intentions to conduct a quality audit. Third, attorneys’ line of questioning is held constant in this experiment in order to provide evidence that audit documentation decisions affect jurors’ decision making. Auditors would benefit from future research examining how plaintiff and defense attorneys use of strategic lines of reasoning based on the evidence documented in the audit workpapers affects jurors’ decision making. Finally, this study only examines the effect of audit documentation decisions on one set of evaluators’ judgments. Audits are subject to evaluation by many other parties, including peers and regulators with auditing experience. As such, future research could examine how audit documentation decisions affect these evaluators’ perceptions of auditors work.
REFERENCES


Lowe, D.J., and P.M.J. Reckers. 1994. The effects of hindsight bias on jurors’ evaluations of

Lowe, D.J., P.M.J. Reckers, and S.M. Whitecotton. 2002. The Effects of Decision-Aid Use and
185-202.

perceived control on the imagination of better and worse possible worlds. *Personality


Oberly, K.A. 2008. Written testimony of Kathryn A. Oberly, Americas Vice Chair and General
Counsel, Ernst & Young LLP, before the Federal Advisory Committee on the Auditing
Profession. Available at: http://www.treas.gov/offices/domestic-
finance/acap/submissions/06032008/Oberly060308.pdf.

Evidence of outcome bias and reverse outcome bias. *Contemporary Accounting Research*

Public Company Accounting Oversight Board (PCAOB). 2004. *Auditing Standard (AS) No. 3 -

Public Company Accounting Oversight Board (PCAOB). 2006. *Due Professional Care in the

Proposal Relating to Judgments Made by Financial Statement Preparers and Auditors.
Available at:
http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2008/02-

- Identifying and Assessing Risks of Material Misstatement*. No. 2010-004, August 5,

The Auditor’s Responses to the Risks of Material Misstatement*. No. 2010-004, August 5,

Reffett, A.B. 2010. Can identifying and investigating fraud risks increase auditors’ liability? *The


APPENDIX A

Consent Form Given to Participants
Informed Consent to Participate in an Experimental Study

Title: The Impact of Audit Evidence Documentation on Jurors’ Negligence Verdicts and Damage Awards

Investigators
E. Michael Bamber
J.M. Tull School of Accounting
240 Brooks Hall
The University of Georgia
(706) 542-3601
mbamber@uga.edu

Ann G. Backof
J.M. Tull School of Accounting
G17A Brooks Hall
The University of Georgia
(706) 542-2022
abackof@uga.edu

Description
My objective is to learn about how jurors evaluate the evidence presented during an auditor negligence trial to arrive at a verdict decision. If you choose to participate in this study, you will be asked to complete a short case study. The choices that you will be asked to make are intended to capture jurors’ decision making. You do not need any prior knowledge or expertise to participate. You will be compensated $10 for your participation in this study. Participants must be 18 years of age or older, U.S. citizens, and eligible to serve on a jury in the United States. Please direct all pertinent questions about this study to the researcher using the contact information provided above.

Risks and Benefits
There are no foreseeable risks or discomforts if you choose to participate in this study. I do not think that there are any risks associated with participating in this study. However, I do believe that by participating in this study you will benefit from the experience of acting as a juror. Many people enjoy participating in these studies and your participation will help researchers better understand how jurors evaluate auditors’ negligence.

Procedures
If you choose to participate in the study, you will be given a case and answer booklet. After reading the material in the case and completing the questions in the answer booklet, you may return the materials to the researcher. It should take you no longer than 30-35 minutes to complete the study. There are no costs associated with helping me with the study.

Confidentiality
Your name will not be associated with any of the data I collect regarding your decisions in the study. You will be identified by a number that will not be linked to your name in any way. The responses will be aggregated and shared, but they will not be individually identifiable.

Right to Refuse Participation or Withdraw
Participation is voluntary; you do not have to take part in this study. If you start the study and decide that you do not want to finish, you may do so at any time. Refusing to participate or withdrawing at any time will not result in penalty or loss of benefits to which you are otherwise entitled.
IRB Approval
This study has been reviewed by the University of Georgia’s Institutional Review Board (IRB). Additional questions or problems regarding your rights as a research participant should be addressed to The Chairperson, Institutional Review Board, University of Georgia, 629 Boyd Graduate Studies Research Center, Athens, Georgia 30602-7411; Telephone (706) 542-3199; E-Mail Address IRB@uga.edu

Statement of Consent
By participating in this study, you indicate that you understand the above information above, you have had an opportunity to ask questions, and all of your questions have been answered to your satisfaction.
APPENDIX B

Experimental Materials
General Instructions

Thank you in advance for participating in this study. The entire study should take about 30 minutes to complete. Your responses are anonymous and will be kept strictly confidential. Because I am interested in individual judgments, please do not talk with your fellow jurors about the study until everyone has completed it.

There are three parts to this study. Part I consists of the auditor negligence trial. You will then make your verdict decision in Part II. Finally, Part III consists of questions about you and your thoughts about the case.

**Part I – Survey and Trial**
Beginning on page 3, you will find a written summary of the auditor negligence trial. Please turn on the audio of the trial and follow along with the written text on the next several pages. After the trial is complete, please place the Part I materials back in the envelope and retrieve the Part II materials.

**Part II – Verdict Decision**
In Part II, you will decide the verdict in this case based on the evidence presented during the trial. Please do not return to Part I. After answering all of the questions in the Part II materials, please place the Part II materials back in the envelope and retrieve the Part III materials.

**Part III – General Questions**
Part III contains general questions about the case and yourself. After answering all of the general questions in the Part III materials, please place the materials back in the envelope and return the envelope containing Parts I, II, and III to the researcher.

Thank you again for your participation!

Please turn the page to begin the trial.
Bierhoff, Ltd. v. Smith & Company  
Case #95210

Complaint: The plaintiff, Bierhoff, Ltd., alleges that the defendant, Smith & Company, was negligent in performing its audit of the 2010 financial statements of Internet-4-All.

Answer: The defendant, Smith & Company, responds that it complied with professional auditing standards and that therefore it was not negligent.

Plaintiff’s Attorney Opening Statement: This case is about auditor negligence. The defendant, Smith & Company, audited Internet-4-All’s 2010 financial statements. My client, Bierhoff, Ltd., received and relied on Internet-4-All’s audited 2010 financial statements, but later found out that those audited financial statements were misstated. Smith & Company’s negligence in the conduct of its audit of Internet-4-All cost Bierhoff, Ltd. $13,000,000 in lost principal and interest on its loan to Internet-4-All.

Financial statements are summaries of a company’s financial information that are given to investors and creditors to help them make informed decisions. Auditors investigate the financial records of a company to determine whether the financial statements are a valid summary of the economic events and transactions that affected the company during the year. The result of auditors’ work is a report that states whether or not the financial statements of a company are accurate, or, put another way, that the financial statements are not materially misstated. “Material” means important, and is often measured in dollars. 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 to whom it matters that the financial statements are not materially misstated.

It is my job to prove to you, on behalf of Bierhoff, Ltd., that Smith & Company was negligent in its performance of the audit of Internet-4-All’s 2010 financial statements. Smith & Company reported that the 2010 financial statements of Internet-4-All were not materially misstated. In other words, Smith & Company gave Internet-4-All a “clean” report. However, after the audited financial statements were released, it came to light that Internet-4-All’s financial statements listed an inventory balance that was $5,000,000 too high. Smith & Company failed to find this huge inaccuracy because the auditors did not perform an audit of sufficient quality; that
is, they did not exercise the same degree of care in their conduct of the audit that other auditors in their position would have used. The $5,000,000 overstatement of inventory hid Internet-4-All’s financial problems from Bierhoff, Ltd., and from others as well. Bierhoff, Ltd. relied on the misstated financial statements when it decided to loan Internet-4-All $10,000,000.

When Internet-4-All’s financial problems came to light, Internet-4-All declared bankruptcy. The company closed and all 100 employees lost their jobs. Because of the terrible job market, many of them are still unemployed now, and others had to accept far less attractive jobs. The stockholders of Internet-4-All suffered large losses when the company declared bankruptcy, and my client has received nothing in return for its loan to Internet-4-All. Bierhoff, Ltd. feels that the auditor who negligently allowed the overstatement to occur should reimburse it for its loss.

I will prove my case by calling Professor Evans, a respected professor specializing in auditing at a major university. Professor Evans will explain how Smith & Company’s poor professional judgment resulted in the $5,000,000 misstatement of the inventory account that hid Internet-4-All’s financial problems and led to my client’s loss.

After I present my case, the defense will present its own expert witness testimony. The defense will claim that Smith & Company satisfied professional auditing standards with the work that it did and that Smith & Company’s judgments were reasonable given the facts available at the time of the audit. Consider carefully whether you believe this to be true and whether the auditors performed their duties in an appropriate manner in this particular case. I am confident that after weighing the evidence you will find for the plaintiff as Smith & Company was negligent in performing its audit of the 2010 financial statements of Internet-4-All and my client suffered as a result of Smith & Company’s negligence.

Defense’s Attorney Opening Statement: The plaintiff has alleged that my client, Smith & Company, was negligent in its audit of Internet-4-All’s 2010 financial statements. The plaintiff makes a point of mentioning the loss of his client, Bierhoff, Ltd. That loss is not relevant in determining whether Smith & Company was negligent in performing its audit of Internet-4-All’s 2010 financial statements. Only the actions and decisions made by Smith & Company, as compared with those that would have been made by other competent CPAs in similar circumstances, are relevant. Further, the losses of parties other than Bierhoff, Ltd. are not relevant to this trial.

Negligence can be established only when an auditor fails to exercise the usual judgment, care, skill, and diligence employed by other Certified Public Accountants (CPAs) in the community. CPAs use the guidance provided in the professional auditing standards to plan and perform their audit work, but the professional auditing standards also require auditors to use their professional judgment throughout an audit. According to the professional auditing standards, auditors must plan and conduct an audit so that they can provide reasonable assurance that the financial statements are free of material misstatements. In other words, an audit conducted in accordance with the professional auditing standards reduces, but cannot completely eliminate,
the chance that people receive misstated financial statements. It is the defense’s position that if an auditor complies with professional auditing standards and makes reasonable professional judgments given the facts available at the time of the audit, he or she has not been negligent. It is my job to prove to you that Smith & Company did just that. I will present evidence that proves that Smith & Company conducted a quality audit in accordance with the auditing standards and used good professional judgment when evaluating the facts available at the time of the audit.

The plaintiff must prove its allegations that Smith & Company was negligent by a preponderance of the evidence. This means that it must show that the charges are more probably true than not true. The plaintiff cannot do so. I will present an expert witness, Ms. Brecht, a respected former partner with a large accounting firm, who will walk you through the audit evidence that proves that Smith & Company conducted a quality audit, made a reasonable professional judgment, and in no way violated professional auditing standards. Smith & Company is a competent, esteemed accounting firm, and I am confident that you will find in its favor.

**Plaintiff’s Attorney:** The plaintiff calls Professor Evans, an accounting/auditing expert witness, to the stand. Professor Evans, please walk us through your evaluation of Smith & Company’s conclusion related to the valuation of Internet-4-All’s inventory account.

**Professor Irene Evans, Accounting/Auditing Expert Witness for the Plaintiff:** Let me begin by explaining to the jury a little bit about Internet-4-All and its inventory account in question. Internet-4-All was a publicly traded corporation in the data networking industry. Internet-4-All faced a great deal of competition in this growing industry and had to constantly monitor the new technologies utilized by its competitors. Internet-4-All’s inventory primarily consisted of routers. A router is a piece of equipment that transmits data, voice, and video information through the Internet. These routers were stored in various warehouses throughout the country.

Accounting standards require that Internet-4-All’s inventory be presented on the 2010 Balance Sheet at the lower of cost or market value. The cost of Internet-4-All’s router inventory represents the total cost that the company paid to produce the routers. This includes the cost of the raw materials such as the cost of the electronic components for the routers, labor costs associated with the workers who worked in the production facility, and overhead costs including the electricity to power the production facility. On the other hand, the market value of Internet-4-All’s router inventory represents the price that the product would sell for in the future. This future selling price is directly impacted by the future demand for the routers. For example, an increase in demand would allow Internet-4-All to sell the routers at a higher price in the future, while a decrease in demand would force Internet-4-All to sell the routers at a lower price.

When auditing the valuation of the inventory account, auditors must use the facts available at the time of the audit to determine whether the market value (or future selling price) of the inventory will be higher or lower than the cost to produce that inventory. According to the accounting standards, Internet-4-All’s router inventory could be reported at cost only if the facts
available at the time of the audit suggested that the market value was higher than the cost to produce the routers. During 2010, the actual sales demand for Internet-4-All’s routers was far below the projected sales demand, yet Internet-4-All did not slow production of its routers. This resulted in a build-up of excess router inventory. Internet-4-All’s biggest competitor also introduced a new router in 2010 that used new fiber optic technology that allowed its users to get online in half the time compared to Internet-4-All’s routers. In my opinion, these facts provided evidence at the time of the audit that the future demand for Internet-4-All’s routers was going to continue to decline, making it hard for Internet-4-All to sell its excess routers based on outdated technology. Companies operating in the data networking industry often use drastic price cuts in order to sell excess inventory based on outdated technology. Therefore, I think that Internet-4-All was going to have to slash the future selling price of its routers below cost in order to sell the large number of routers that were sitting in its warehouses. As such, I think that it was clear at the time of the audit that the market value of Internet-4-All’s routers was lower than cost and inventory must be presented at the lower of cost or market value. Therefore, it is my opinion that Smith & Company should not have allowed Internet-4-All to present the router inventory at cost on the Balance Sheet.

When Smith & Company allowed Internet-4-All’s router inventory to be presented at cost on the Balance Sheet, Internet-4-All appeared to be financially sound. In other words, there was no indication that Internet-4-All was having financial problems based on the 2010 financial statements. Consequently, Bierhoff, Ltd. decided to loan Internet-4-All $10,000,000. However, it came to light after the audited financial statements were released that Internet-4-All’s inventory balance was $5,000,000 too high. In other words, Internet-4-All’s router inventory was worth $5,000,000 less than the cost of those routers presented in the financial statements. This $5,000,000 overstatement of inventory hid Internet-4-All’s financial problems from the users of the financial statements, including Bierhoff Ltd. If Smith & Company had not allowed Internet-4-All to report its router inventory at cost but instead required Internet-4-All to write its router inventory down to a lower market value, I think that Internet-4-All’s financial problems would have been clear and Bierhoff, Ltd. never would have loaned Internet-4-All $10,000,000. As such, it is my opinion that Smith & Company did not use good professional judgment when they allowed Internet-4-All to report the router inventory at cost given the facts available at the time of the audit that clearly suggested that the market value of Internet-4-All’s router inventory was below cost.

Defense’s Attorney Cross-examination: Professor Evans, although you personally believe that the facts clearly suggested that the market value of the router inventory was lower than cost, were there any other facts available at the time of the audit that supported leaving the inventory at cost?
**Professor Irene Evans, Accounting/Auditing Expert Witness for the Plaintiff:** Yes, in addition to the facts that suggested that the market value of the router inventory was lower than cost, there were also some facts that suggested that the market value of the router inventory was higher than cost.

**Plaintiff’s Attorney:** Thank you Professor Evans. If the defense has no more questions, the plaintiff calls Ms. Wood, a damages expert witness, to the stand. Ms. Wood, in your professional opinion, how much did Bierhoff, Ltd. lose when Internet-4-All declared bankruptcy?

**Ms. Wood, Damages Expert Witness for the Plaintiff:** As you stated in your opening statement, the plaintiff, Beirhoff, Ltd., loaned Internet-4-All $10,000,000 based on Internet-4-All’s misstated 2010 financial statements. Beirhoff, Ltd. loaned Internet-4-All this money for 5 years at an interest rate of 7.5%. However, Internet-4-All went bankrupt before Bierhoff, Ltd. received any payments on this loan. Consequently, Beirhoff, Ltd. not only lost the $10,000,000 of loan principal, but Beirhoff, Ltd. also lost all of the interest payments that it would have earned over the 5 years the loan was outstanding. These future interest payments have a present value of just over $3,000,000. Therefore, in my opinion, Bierhoff, Ltd. suffered $13,000,000 in damages due to its reliance on Internet-4-All’s misstated financial statements.

**Plaintiff’s Attorney:** Thank you Ms. Wood. If the defense has no questions, the plaintiff rests.

**Defense’s Attorney:** The defense calls Ms. Brecht, an accounting/auditing expert witness, to the stand. Ms. Brecht, please walk us through your assessment of Smith & Company’s audit work performed on the inventory account.

**Ms. Joanne Brecht, Accounting/Auditing Expert Witness for the Defense:** Before providing my assessment of Smith & Company’s audit work, I think it is important that the jury understands that auditors are required to conduct an audit in accordance with the professional auditing standards. Auditors comply with this requirement by following the guidance provided within the professional auditing standards regarding how auditors should plan and perform an audit, as well as how auditors should make professional judgments.

In terms of planning and performing the audit, the professional auditing standards require auditors to identify the risks of material misstatement for each significant account and gather sufficient appropriate evidence to support their conclusion that the financial statements are not misstated due to any of the identified risks of material misstatement. All auditors must document the identified risks and the audit work performed to address those risks in their audit workpapers. Therefore, I direct the jury’s attention to Exhibit 1 that summarizes Smith & Company’s audit of Internet-4-All’s inventory account.
Exhibit 1 captures the risks of material misstatement that Smith & Company identified, the audit procedures that Smith & Company performed during their audit of the inventory account, and a summary of Smith & Company’s findings for each audit procedure. As you can see in Exhibit 1, Smith & Company identified two main risks of material misstatement for Internet-4-All’s inventory account: (1) the value of the inventory is incorrect and/or (2) the quantity of the inventory is incorrect. Smith & Company tested the procedures that Internet-4-All had in place to prevent and/or detect misstatements in the inventory account, as well as compared year-over-year changes in certain accounting ratios. Smith & Company also carried out detailed testing of the inventory account. For example, Smith & Company counted a sample of Internet-4-All’s inventory in the warehouses and agreed the details of their count to the inventory records. In addition, Smith & Company independently reviewed the facts available at the time of the audit to determine whether the market value of Internet-4-All’s inventory was lower or higher than the cost of that inventory. A summary of Smith & Company’s findings for each audit procedure is documented beneath the audit procedure in italicized text in Exhibit 1.

It is important that the jury understands that the auditing standards did not require Smith & Company to provide 100% assurance that Internet-4-All’s financial statements were free of material misstatements. Rather, the auditing standards required Smith & Company to perform enough audit work on Internet-4-All’s inventory account that would allow Smith & Company to provide reasonable assurance that Internet-4-All’s financial statements were not materially misstated. In order to provide this reasonable assurance, the professional auditing standards required Smith & Company to identify the risks of misstatements in Internet-4-All’s inventory account and to perform audit work to address each identified risk. The plaintiff’s expert witness, Professor Evans, focused only on Smith & Company’s decision to allow Internet-4-All’s inventory to be presented at cost. However, as the jury can see in Exhibit 1, this represents only one piece of the audit work that Smith & Company performed to specifically address the risk that Internet-4-All’s inventory was reported at the incorrect value.
Exhibit 1

(See APPENDIX C for Manipulations)
In addition to requiring auditors to gather evidence to address each identified risk of material misstatement, auditing standards also require auditors to use their professional judgment when evaluating that evidence. The plaintiff argues that Smith & Company should not have allowed Internet-4-All to present its router inventory at cost. However, the facts available at the time of the audit were ambiguous as to the future selling price of those routers. Therefore, Smith & Company had to use their professional judgment to decide on the correct valuation of the inventory. Given the importance of Smith & Company’s professional judgment regarding the valuation of the router inventory to this case, I direct the jury’s attention to Smith & Company’s workpaper #1000-3 that is entered into evidence as Exhibit 2.

In order to make a good professional judgment, the auditing standards require auditors to objectively evaluate all of the facts available at the time of the audit. Therefore, Smith & Company considered the facts consistent with reporting the router inventory at the cost, as well as those suggesting the need to write the router inventory down to a lower market value. Smith & Company documented its evaluation of these facts in Exhibit 2.

During 2010, Internet-4-All’s router was selling, but sales were lower than expected due to the sluggish economy. After receiving a glowing review, Internet-4-All expected its router sales to pick back up when the economy rebounded. Further, unlike its competitor’s router, Internet-4-All’s routers worked with the existing telephone lines found throughout the United States. Taken together, these facts suggested that the demand for Internet-4-All’s router would increase in the future, enabling Internet-4-All to sell the routers at a price that was greater than the cost paid to produce the routers. In my opinion, Smith & Company’s conclusion reached in Exhibit 2 was reasonable.

**Plaintiff’s Attorney Cross-examination:** Ms. Brecht, with respect to the router inventory valuation decision, is it possible that the facts available at the time of the audit could have led other auditors to a different conclusion?

**Ms. Joanne Brecht, Accounting/Auditing Expert Witness for the Defense:** As I mentioned earlier, there were facts that indicated that the demand for the routers would increase, resulting in a future selling price that was greater than the cost to produce the routers. On the other hand, as Professor Evans noted, there were also facts that suggested that the demand for the routers would stay low, forcing Internet-4-All to drop the future sales price below cost. Therefore, it is possible that while Smith & Company concluded that Internet-4-All’s router inventory should be presented at cost, some other auditors could have concluded that the inventory should be valued at a lower market value. However, given the ambiguous facts available at the time of the audit, what is relevant to this case of alleged auditor negligence is whether or not Smith & Company objectively evaluated the facts consistent with reporting Internet-4-All’s router inventory at cost, as well as those facts suggesting the need to write the inventory down to a lower market value before making their conclusion.
Exhibit 2

(See APPENDIX D for Manipulations)
Defense’s Attorney: Thank you Ms. Brecht. If the plaintiff has no more questions, the defense calls Ms. Brown, a damages expert witness, to the stand. Ms. Brown, in your professional opinion, did Bierhoff, Ltd. lose $13,000,000 due to Internet-4-All’s bankruptcy?

Ms. Brown, Damages Expert Witness for the Plaintiff: No, I do not think that Bierhoff, Ltd. suffered damages of $13,000,000. During bankruptcy, Internet-4-All’s assets will be sold and the proceeds will be divided between Internet-4-All’s creditors. However, the proceeds from the sale of these assets will not cover all of Internet-4-All’s debts. Thus, there is a priority system dictating which creditors get paid first. As a secured creditor, the principal of the loan that Bierhoff, Ltd provided to Internet-4-All will be repaid before any unsecured creditor. Therefore, in my opinion, Bierhoff, Ltd. will only lose the interest it would have earned on the loan, which is presently valued at a little over $3,000,000.

Defense’s Attorney: Thank you Ms. Brown. If the plaintiff has no questions, the defense rests.

Plaintiff Closing Statement: The testimony you have heard today established that Smith & Company was negligent in its audit of Internet-4-All’s 2010 financial statements. The defense claims that Smith & Company reached a reasonable conclusion regarding the valuation of the router inventory given the facts available at the time of the audit. However, as Professor Evans noted, the main issue is that Smith & Company allowed the router inventory to be presented at cost even though there were facts that clearly suggested that the market value of the router inventory was lower than the cost of that inventory. This presentation of Internet-4-All’s router inventory at cost hid Internet-4-All’s financial problems from Bierhoff, Ltd. and other users of the misstated financial statements. Smith & Company’s audit decisions then resulted in a $13,000,000 loss for Bierhoff, Ltd., large losses for the stockholders of Internet-4-All, and loss of jobs for all 100 of the company’s employees. All of these innocent parties counted on Smith & Company to do its job, and Smith & Company failed them.

Society expects more from auditors. We expect auditors to exercise the same judgment, care, skill, and diligence employed by other auditors when planning and performing an audit. Therefore, we expect all auditors to adhere to the professional auditing standards that require auditors to gather evidence to address the identified risks of material misstatement, as well to objectively evaluate all of the facts available at the time of the audit. We expect auditors who adhere to these professional auditing standards to be able to find $5,000,000 misstatements such as the one in Internet-4-All’s inventory account. Smith & Company simply did not live up to society’s expectations. Thus, I urge you to find for the plaintiff in this case.

Defense Closing Statement: The plaintiff has told you that Smith & Company was negligent in its audit of Internet-4-All’s 2010 financial statements. It is your job to evaluate whether the evidence presented today supports this allegation.

Did Smith & Company conduct an audit in accordance with the professional auditing
standards? Yes. As Ms. Brecht explained, Smith & Company identified two risks of material misstatement in Internet-4-All’s inventory account and performed audit work to address those risks. Exhibit 1 captures Smith & Company’s approach to auditing the inventory account. In terms of the router inventory valuation decision, Ms. Brecht pointed out that the facts available at the time of the audit were ambiguous and it was not clear whether Internet-4-All’s router inventory should be reported at cost or a lower market value. Exhibit 2 captures Smith & Company’s analysis of these facts and their conclusion based on their analysis that it was reasonable to report the inventory at cost.

Thus, the evidence proves that Smith & Company performed an audit that complied with the professional auditing standards. The plaintiff has failed to demonstrate otherwise. Accordingly, I urge you to find in favor of the defendant, Smith & Company.

Judge’s Instructions to the Jury: It is your responsibility to determine the facts of this case from the evidence presented to you. You will use these facts and the law given in these instructions to decide the case. You should consider the evidence in light of your own observations and experiences in life. You may draw any reasonable inferences from the proven facts. Keep in mind that opening and closing statements made by attorneys are not evidence.

The burden of proof lies with the plaintiff. The level of proof required is the preponderance of the evidence, which means that the charges are more probably true than not true. In order to be successful on a claim of professional negligence, the plaintiff must prove by a preponderance of the evidence that Smith & Company failed to exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community. You should consider whether the defendant complied with professional auditing standards in making your evaluation. If you decide that the preponderance of evidence suggests that the defendant, Smith & Company, did exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community, you must find in its favor. If you decide that the preponderance of evidence suggests that Smith & Company did not exercise the usual judgment, care, skill, and diligence employed by other CPAs in the community, you must find for the plaintiff, Bierhoff, Ltd.

You have now completed Part I.
Please return these materials to the envelope and retrieve the Part II materials.
Do not return to the Part I materials.
Bierhoff, Ltd. v. Smith & Company
Verdict Decision
Part II
Please read the summary of the charges and jury instructions provided below. Do not return to the Part I materials.

_Bierhoff, Ltd. v. Smith & Company_

Case Summary

**Complaint:** The plaintiff, Bierhoff, Ltd., alleges that the defendant, Smith & Company, was negligent in performing its audit of the 2010 financial statements of Internet-4-All.

**Answer:** The defendant, Smith & Company, responds that it complied with auditing standards and that therefore it was not negligent.

**Summary of Jury Instructions:** It is your responsibility to determine whether or not Smith & Company was negligent based on the evidence presented to you during the trial. Auditors are required to use the same judgment, care, skill, and diligence employed by other CPAs in the community. Auditors comply with this standard of care by adhering to the professional auditing standards. Therefore, you should consider whether the defendant complied with professional auditing standards in making your evaluation. If you believe that the evidence suggests that for the most part Smith & Company acted as other CPAs would have given the same circumstances, then you should conclude that Smith & Company is not guilty of negligence. On the other hand, if you decide that the majority of evidence suggests that Smith & Company did not act as other CPAs would have given the same circumstances, you should conclude that Smith & Company is guilty of negligence.

**Exhibit Index:** In accordance with the American Bar Association, you are provided the two exhibits entered into evidence during the trial. You are allowed to refer to these exhibits during the deliberation process.

- **Exhibit 1** summarizes all of the work Smith & Company performed during their audit of the inventory account.
- **Exhibit 2** captures Smith & Company’s analysis of the facts available at the time of the audit related to the valuation of the router inventory.

Please turn the page to view Exhibits 1 and 2.
Exhibit 1 summarizes all of the work Smith & Company performed during their audit of the inventory account.
Exhibit 1

(See APPENDIX C for Manipulations)
Exhibit 2 captures Smith & Company’s analysis of the facts available at the time of the audit related to the valuation of the router inventory.
Exhibit 2

(See APPENDIX D for Manipulations)

Please turn the page.
Please answer all of the following questions.

1. How likely is it that Smith & Company was negligent? (Place an “X” on the scale to indicate your response.)

<table>
<thead>
<tr>
<th>Not at all</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10 Likely</th>
</tr>
</thead>
</table>

2. You will now cast your vote for the verdict. If the jury took a poll before deliberations, how would you vote? (Check the appropriate line below. You are not allowed to abstain.)

   ________ Smith & Company was negligent.

   ________ Smith & Company was not negligent.

3. If you voted negligent, what dollar amount in damages would you recommend be awarded to Bierhoff, Ltd (the plaintiff)? (If you voted negligent, fill in an amount from $0 to $13,000,000 below. If you voted not negligent, leave this line blank.)

   $ ______________________________

Please return these materials to the envelope and retrieve the Part III materials. Do not return to or change the Part II materials.
Bierhoff, Ltd. v. Smith & Company
General Questions
Part III
General Questions

Please answer all of the following questions in order.

1. Given what you know about Smith & Company (the audit firm), do you have a favorable or unfavorable impression of the audit firm?

<table>
<thead>
<tr>
<th>Very</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Favorable</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
</tr>
</tbody>
</table>

2. Did Smith & Company’s (the audit firm) actions cause Bierhoff, Ltd’s (the plaintiff) loss?

   | Not at all | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
   | Cause     | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

3. Did Smith & Company (the audit firm) intend to conduct a quality risk-based audit by identifying the risks of material misstatement and performing audit work to specifically address each of those identified risks?

   | Not at all | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
   | Intended  | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

4. An event is foreseeable when the facts available at that point in time indicate that the event will likely happen. Was the overstatement of inventory foreseeable given the facts available at the time of the audit?

   | Not at all | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
   | Foreseeable | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |

5. How much blame does Smith & Company (the audit firm) deserve for Bierhoff, Ltd’s (the plaintiff) loss?

   | None of the | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
   | Blame      | 0 | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
6. While reading the case and making your judgments, what were your feelings towards Bierhoff, Ltd (the plaintiff)?

<table>
<thead>
<tr>
<th>Very Negative</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

7. While reading the case and making your judgments, what were your feelings towards Smith & Company (the audit firm)?

<table>
<thead>
<tr>
<th>Very Negative</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

8. How important was it to you to follow the judge’s instructions to focus on the evidence presented at trial?

<table>
<thead>
<tr>
<th>Not at all Important</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

9. How hard did you work to understand the evidence presented at trial?

<table>
<thead>
<tr>
<th>Not at all Hard</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

10. How seriously did you think about what Smith & Company (the audit firm) could have done differently to detect the misstatement in the inventory account?

<table>
<thead>
<tr>
<th>Not at all Seriously</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

11. How upsetting was it that Internet-4-All’s bankruptcy resulted in employees losing their jobs, investors losing money, and Bierhoff, Ltd (the plaintiff) losing $13,000,000 in loan principal and interest?

<table>
<thead>
<tr>
<th>Not at all Upsetting</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
</table>

12. Why was Internet-4-All’s inventory account overstated? (Check all that apply)

_____ The quantity of the inventory was incorrect.
_____ The value of the inventory was incorrect.
_____ None of the above. Please specify reason ____________________________________________
13. How important was the evidence presented in *Exhibit 1* capturing Smith & Company’s (the audit firm) *Inventory Audit Approach* when you were making your verdict decision?

Not at all [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Extremely Important

14. How important was the evidence presented in *Exhibit 2* capturing Smith & Company’s (the audit firm) *Inventory Valuation Analysis* when you were making your verdict decision?

Not at all [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Extremely Important

15. How easy was it to understand what audit procedures Smith & Company (the audit firm) performed to address each risk they had identified?

Very [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Very Easy

16. To what extent did Smith & Company (the audit firm) *comply* with the auditing standards that require auditors to *identify the risks of material misstatement and perform audit work to address each identified risk*?

No [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Full Compliance

17. How reasonable was Smith & Company’s (the audit firm) decision to allow the router inventory to be reported at cost given all of the facts available at the time of the audit?

Not at all [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Completely Reasonable

18. To what extent did Smith & Company (the audit firm) *comply* with the auditing standards that require auditors to *objectively evaluate all of the evidence* (i.e., facts consistent with reporting at cost and facts consistent with writing down to a lower market value) related to the valuation of the router inventory?

No [_____|_____|_____|_____|_____|_____|_____|_____|_____|_____] Full Compliance
Finally, please tell me a little bit about yourself.

19. What is your highest education level? (Circle one.)

- Some High School
- Completed High School (or Equivalent)
- Completed Trade or Professional School
- Some Graduate School
- Completed Graduate School
- Some College

20. What is your age? __________

21. What is your gender? _____ Male _____ Female

22. Have you taken any accounting courses? _____ Yes _____ No
   If so, how many? _________________________.

23. Do you have any audit experience (including an internship)? _____ Yes _____ No
   If so, how many months of experience? _________________________.

24. Are you currently or have you ever been
   - a Certified Public Accountant? _____ Yes _____ No
   - an auditor? _____ Yes _____ No
   - upper- or middle-management in a business? _____ Yes _____ No
   - an investor? _____ Yes _____ No
   - an attorney? _____ Yes _____ No

25. Have you ever served as a juror before today? If yes, how many times?
   _____ Yes, _______ times on civil trials and _______ times on criminal trials.
   _____ No, never.

26. If you have served as a juror before today, how long ago was your most recent service?
   _____ years and _____ months ago

After you answer all of the questions, please return the Part III materials to the envelope.
You have now completed the study.
Please return the envelope to the researcher.

Thank you again for participating in this study. Your time and effort are greatly appreciated!
APPENDIX C

Documentation of Risk-Based Audit Approach Manipulations
Exhibit 1

Smith & Company
Inventory Audit Approach
(Does Not Reflect Risk-Based Audit Approach)

INVENTORY

**Identified Risk 1:** Risk of material misstatement of ending inventory due to **incorrect valuation**

**Identified Risk 2:** Risk of material misstatement of ending inventory due to **incorrect quantity**

**Audit procedures:**

1. Test Internet-4-All’s procedures for identifying obsolete inventory.
   - Management’s procedures for identifying obsolete inventory appear satisfactory based on our testing.

2. Compare how many times inventory was sold and replaced during 2010 with 2009.
   - The number of times inventory was sold and replaced decreased this year. CFO suggested this was due to the slowing of the general economy.

3. Determine if the market value of the inventory is lower than the cost.
   - Inventory must be presented at the lower of the cost to produce the routers or the future selling price of the routers. Based on our analysis of the facts available at the time of the audit, it is reasonable for the router inventory to be presented at cost on the Balance Sheet.

4. Test Internet-4-All’s inventory count procedures and observe inventory count at 5 warehouses to assess whether they are followed.
   - Management’s inventory count procedures appear satisfactory based on our observation of inventory counts at 5 warehouses.

5. Compare the average number of days that it took to sell the average amount of inventory held during 2010 to 2009.
   - It took longer to sell the average inventory this year. CFO suggested this was due to the slowing of the general economy.

6. Observe physical inventory count at 5 warehouses that store the majority of the inventory. Trace a sample of inventory in the inventory records to the warehouse and tracing a sample of inventory in the warehouse to the inventory records.
   - No problems noted.

**Conclusion:**

Based on the audit work that we performed and the facts available at the time of the audit, we conclude that Internet-4-All's inventory is not materially misstated due to the incorrect valuation of the inventory account or the incorrect quantity of inventory being reported in the inventory account.
Exhibit 1

*Smith & Company*

Inventory Audit Approach

*(Reflects Risk-Based Audit Approach)*

### INVENTORY

**Identified Risk 1: Risk of material misstatement of ending inventory due to incorrect valuation**

**Audit procedures:**

1. Test Internet-4-All’s procedures for identifying obsolete inventory.
   
   ⇒ Management’s procedures for identifying obsolete inventory appear satisfactory based on our testing.

2. Compare how many times inventory was sold and replaced during 2010 with 2009.
   
   ⇒ The number of times inventory was sold and replaced decreased this year. CFO suggested this was due to the slowing of the general economy.

3. Determine if the market value of the inventory is lower than the cost.
   
   ⇒ Inventory must be presented at the lower of the cost to produce the routers or the future selling price of the routers. Based on our analysis of the facts available at the time of the audit, it is reasonable for the router inventory to be presented at cost on the Balance Sheet.

**Conclusion:**

Based on the audit work that we performed and the facts available at the time of the audit, we conclude that Internet-4-All's inventory is not materially misstated due to the incorrect valuation of the inventory account.

**Identified Risk 2: Risk of material misstatement of ending inventory due to incorrect quantity**

**Audit procedures:**

4. Test Internet-4-All’s inventory count procedures and observe inventory count at 5 warehouses to assess whether they are followed.
   
   ⇒ Management’s inventory count procedures appear satisfactory based on our observation of inventory counts at 5 warehouses.

5. Compare the average number of days that it took to sell the average amount of inventory held during 2010 to 2009.
   
   ⇒ It took longer to sell the average inventory this year. CFO suggested this was due to the slowing of the general economy.

6. Observe physical inventory count at 5 warehouses that store the majority of the inventory. Trace a sample of inventory in the inventory records to the warehouse and tracing a sample of inventory in the warehouse to the inventory records.
   
   ⇒ No problems noted.

**Conclusion:**

Based on the audit work that we performed and the facts available at the time of the audit, we conclude that Internet-4-All's inventory is not materially misstated due to the incorrect quantity of inventory being reported in the inventory account.
APPENDIX D

Documentation of Consideration of Alternative Accounting Treatments Manipulations
Exhibit 2  
*Smith & Company*  
Inventory Valuation Analysis  
WP #1000-3  
*(No Alternatives Presented)*

**Relevant Accounting Standard:**  
Inventory must be presented on the Balance Sheet at the *lower of cost or market value*.

**Issue:**  
Is the market value of Internet-4-All’s router inventory less than the cost to produce the routers?

**Analyze Issue:**

<table>
<thead>
<tr>
<th>Reasons to report inventory at cost:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internet-4-All’s router is selling, although the amount of sales is lower than expected. Mr. Alwright, Internet-4-All’s CFO, explained that the lower-than-expected demand is not permanent and is simply due to a sluggish economy.</td>
</tr>
<tr>
<td><em>DataNet Review</em> magazine gave a glowing review of both Internet-4-All’s router and its competitor’s router. This supports the potential for the demand for Internet-4-All’s router to increase in the future.</td>
</tr>
<tr>
<td>Internet-4-All’s router works throughout the United States, while the competitor’s router requires fiber optic cables that are only available in certain parts of the country.</td>
</tr>
</tbody>
</table>

**Conclusion:**  
It is likely that the demand for Internet-4-All’s router will increase in the future as the economy starts to recover. This increase in demand will enable Internet-4-All to sell the routers at a price that is higher than the cost of those routers. Therefore, based on our analysis of the facts available at the time of the audit, we conclude that it is reasonable for Internet-4-All’s router inventory to be reported at cost on the Balance Sheet.

Completed by: *Brad Tucker*  
Reviewed by: *Chase Stevens*
Exhibit 2
Smith & Company
Inventory Valuation Analysis
WP #1000-3
(Alternatives Presented)

Relevant Accounting Standard:
Inventory must be presented on the Balance Sheet at the lower of cost or market value.

Issue:
Is the market value of Internet-4-All’s router inventory less than the cost to produce the routers?

Analyze Issue:

<table>
<thead>
<tr>
<th>Reasons to report inventory at cost:</th>
<th>Reasons to write inventory down to market:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internet-4-All’s router is selling, although the amount of sales is lower than expected. Mr. Alwright, Internet-4-All’s CFO, explained that the lower-than-expected demand is not permanent and is simply due to a sluggish economy.</td>
<td>Sales for Internet-4-All’s routers have been steadily declining each month over the past year, but Internet-4-All did not slow production of its routers in response to this decline in demand. This resulted in a build-up of router inventory.</td>
</tr>
<tr>
<td>DataNet Review magazine gave a glowing review of both Internet-4-All’s router and its competitor’s router. This supports the potential for the demand for Internet-4-All’s router to increase in the future.</td>
<td>According to DataHub magazine, the competitor’s router using fiber optic technology is superior for data transmission because fiber optic cables allow the data to be transmitted at much faster speeds.</td>
</tr>
<tr>
<td>Internet-4-All’s router works throughout the United States, while the competitor’s router requires fiber optic cables that are only available in certain parts of the country.</td>
<td>Due to the rapid technological changes in the data networking industry, severe price cuts are often used to sell products that are based on outdated technology.</td>
</tr>
</tbody>
</table>

Conclusion:
It is likely that the demand for Internet-4-All’s router will increase in the future as the economy starts to recover. This increase in demand will enable Internet-4-All to sell the routers at a price that is higher than the cost of those routers. Therefore, based on our analysis of the facts available at the time of the audit, we conclude that it is reasonable for Internet-4-All’s router inventory to be reported at cost on the Balance Sheet.

Completed by: Brad Tucker
Reviewed by: Chase Stevens