DOES AUDIT STRUCTURE AND ACCOUNTING/AUDITING KNOWLEDGE AFFECT JUDGMENTS IN AN AUDITOR LITIGATION SETTING?

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Abstract

Litigation risk remains a major concern of accounting firms, which must abide by decisions made by judges or jurors with little or not expertise in accounting or auditing procedures. This paper tests whether specific descriptions of the audit structure employed by the accounting firm affect juror decisions of audit quality and auditor liability. Two groups of university students proxied for jurors. One group has little or no accounting knowledge, while the other group was comprised of auditing students, familiar with the expectations and requirements of an audit. Auditing students judged audit quality to be higher and auditor liability to be less in every scenario. However, decisions were unaffected by description or nature of the audit structure (either highly structured or unstructured).

BACKGROUND AND HYPOTHESIS DEVELOPMENT

Guilty or innocent. Liable or faultless. Decisions made in our courts of law are among the most high-profile decisions in our society. The decisions are often made by a jury of "peers," ordinary people who have no particular knowledge of or interest in

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the issue being decided. It is assumed that their decision is based on the information that is presented to them by both the plaintiff (accuser) and the defendant. But it is not just factual information that affects decisions. Jurors also bring varying backgrounds and pre-established opinions that affect their evaluations and decisions about a case.

These issues affect the accounting profession in the instance of auditor litigation. Legal liability is a major concern and expense for auditing firms. For example, in 1993, the Big Six audit firms spent over a billion dollars on litigation settlements, costing 11.9% of their annual revenue even after insurance payoffs.[1] Legal costs and the incidences of litigation have increased considerably in recent years.[2] With increased focus on the accounting profession due to major corporate scandals and the implementation of the Sarbanes-Oxley Act, auditor liabilities remain at the forefront. In a Business Finance article,[3] Eugene D. O'Kelly, chairman and CEO of PMG LLP, notes that double digit practice-protection costs are second only to compensation costs in the accounting industry, and contribute to a decrease in accounting firm's distribution to partners, even while firms' earnings have increased.

Jury Decision Making

Knowledge of how potential jurors decide is of value to an audit firm faced with litigation. Previous research has shown that there is an expectation gap between what auditors and other members of the public think of the role and responsibility of

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[1] Wermert, John G.) Outcome effects in the evaluation of auditor performance in trial settings: the role of evidence recall, interpretation and weighting. Unpublished Manuscript, Drake University. (May 1998)

[2] Kathryn Kadous, "The effects of audit quality and consequence severity on juror evaluations of auditor responsibility for plaintiff loss," The Accounting Review, Vol. 75:3 (July 2000), 327-341

[3] John Cummings, 2005. News Scan: Audit firms feel the heat. Business Finance. Vol. 11 (April 2005), 45

auditors.[4] Jennings, Reckers and Kneer[5] suggest that auditor liability may depend most importantly on the attitudes of jurors and judges toward the auditing profession. They compared audit liability judgments of judges, attorneys and CPAs, finding that attorneys and judges have different prebeliefs about an auditor's role in preparing a client's financial statements, setting materiality standards and disclosure levels, and in being an insurer against stockholder losses. Several studies have shown that supplementary information about an audit or auditor can influence juror assessments of audit quality and auditor liability. Buckless and Pearce,[6] using jury pool members as subjects, found a difference in evaluation of auditor liability depending on the perceived source of auditing standards.

Audits following governmental standards were evaluated more highly than those adhering to generally accepted accounting principles that are set by the industry itself. Lowe et al.,[7] also using jury pool participants, found that juror's responses to the auditor's use of decision aids varied with the reliability of the aid, and the use the auditor made of that aid. Brandon et al.[8] found that a client's importance to the auditor (measured by percent of local accounting office fees the client represented) affected juror

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[4]William R. Kinney Jr. and Mark W. Nelson, "Outcome information and the "expectation gap": the case of loss contingencies," Journal of Accounting Research, Vol. 34 (Autumn, 1996), 281-299.

[5] Marianne M. Jennings, Phillip M.J. Reckers and Daniel C. Kneer, "The auditor's dilemma: The incongruous judicial notions of the auditing profession and actual auditor practice," American Business Law Journal, Vol. 29 (Spring 1991), 99-125 at 101-102.

[6]Frank A. Buckless and Robert L. Peace, "The influence of the source of professional standards on juror decision making," The Accounting Review Vol. 68:1 (January 1993), 164-174.

[7] D. Jordan Lowe, Phillip M.J. Reckers and Stacey M. Whitecotton, "The effects of decision-aid use and reliability on jurors' evaluations of auditor liability," The Accounting Review, Vol. 77 (January, 2002), 185-202

[8] Duane M. Brandon and Jennifer M. Mueller, "The influence of client importance on juror evaluations of auditor liability," Behavioral Research in Accounting, Vol. 18 (2006), 1-18.

surrogates assessments of auditor blame when the client went bankrupt after it was issued a clean opinion. By asking juror surrogates to evaluate auditors in an audit failure situation, Kadous[9] found that high audit quality resulted in higher evaluations of an auditor when loss due to the audit failure was less severe, but for more severe consequences, audit quality had no effect.

Juror Accounting Knowledge

According to Jennings, Reckers and Kneer[10] (1991), an expectation gap exists between CPAs who perform audits, and judges and lawyers who judge auditor liability. The expectation gap may be mitigated for those who are more aware of the standards and procedures for preparing and auditing financial statements. The authors suggest that knowledge of accounting practices and procedures may affect jurors attitudes about the accounting profession, and their liability and damages decisions. This study tests this premise. In this experiment, the level of accounting and auditing knowledge is manipulated between subjects with little or no knowledge of accounting and auditing (students in the first basic accounting course) and students with an intermediate level of accounting and auditing knowledge (students in an upper level auditing class). If even a basic familiarity with accounting and auditing procedures narrows the expectation gap between accountants and others, audit quality and auditor liability judgments may be affected. Hypothesis one, stated in alternative form is:

> H1. Evaluations of the quality of the auditor's decision to issue an unqualified ("clean") opinion (and asssessments of audit firm liability) will be lower (higher) for juror surrogates with little or no accounting and auditing knowledge than for juror surrogates with an intermediate level of accounting and auditing knowledge.

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[9] Kadous 2000 at 327.

[10] Jennings et al. at 121.

Audit Structure

This paper also tests whether the inclusion of additional information about the audit firm, in particular, a description of the audit structure methodology used by an audit firm would affect juror assessments. Some major audit firms have been moving to implement more highly structured audits[11], in order to increase audit efficiency and consistency[12] and to save on costs.[13] Cushing and Loebbecke,[14] however, also suggest that the high and objective quality of such audits might be an advantage in a litigation setting. Wermert[15] too suggests that the use of a well-documented structured audit methodology might reduce juror's tendencies to weight evidence consistent with a negative financial outcome more heavily when evaluating an auditor's performance. The greater objectivity and documentation achieved in highly structured audits through extensive use of decision aids might favorably influence jurors. On the other hand, firms using unstructured audit methodology utilize more expert auditors to appropriately determine the type and extent of testing on an individual audit basis.[16] Also, firms using an unstructured methodology will customize the audit procedures based on the individual client. Both the objectivity and documentation of high audit structure, and the flexibility and auditor expertise level of unstructured audits can

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[11] Linda S. McDaniel, "The effects of time pressure and audit program structure on audit performance," Journal of Accounting Research, Vol. 28:2, (Autumn 1990), 267-285 at 269.

[12] Barry Cushing and James K. Loebbecke, " Comparison of audit methodologies of large accounting firms," Studies in Accounting Research #26, (1986), Sarasota FL: American Accounting Association, 41-42.

[13] Willie E. Gist, "Empirical evidence of the effect of audit structure on audit pricing," Auditing: A Journal of Practice and Theory, Vol. 13:2 (Fall 1994), 25-40, at 25.

[14] Cushing and Loebbecke, at 41.

[15] Wermert at 21.

[16] Douglas F. Prawitt, "Staffing assignments for judgment-oriented audit tasks: the effects of structured audit technology and environment," The Accounting Review, Vol. 70:3, (July 1995), 443-465, at 446-447.

be viewed as enhancing the quality of an audit. This leads to the question: Does the specific description of audit structure affect juror's evaluations of audit quality and the assessments of the extent of audit firm liability when a material misstatement is subsequently discovered after an audit firm has given an unqualified (standard) audit opinion? The second hypothesis, stated in the alternative form is

> H2. Evaluations of audit quality and assessments of audit firm liability will be different when an audit is described as highly structured, compared to an audit described as unstructured and an audit where no audit structure is specifically mentioned.

If differences exist, additonal analyses could address whether it is simply the additional knowledge about the audit firm that causes the difference, or if it is the structure itself that affects responses.

Framing: Primacy And Recency Effects

The above hypotheses assume that a defendant has chosen to include a favorably worded reference to the audit structure used. However, opposing counsel could counter by putting an unfavorable spin on the same audit structure. For instance, the plaintiff could argue that a highly structured audit is too objective and impersonal (a "canned" audit program), or that the lack of structure in an unstructured audit allows the auditor to be unduly influenced by the client. Primacy suggests that a juror's judgments would not be affected when positive (negative) audit structure description is subsequently described negatively (positively). Recency suggests that the most recent description would affect judgments. The possibility of the audit structure description backfiring is addressed as research question one.

> RQ1: Are jurors' evaluations of audit quality and assessments of audit firm liability negatively (positively) affected when the audit structure description goes from positve to negative (negative to positive)?

Students As Juror Surrogates

Since direct observation of jury deliberation is prohibited, experiments are necessarily done with juror surrogates. MacCoun[17] (1989) reports that studies have found little or no difference between decisions made by adult juror surrogates and those made by college students. Likewise, "mock" juror decisions have been shown to be similar to actual juror decisons. Kadous[18] (2001) used three groups of jurors(those on a jury list, a random selection of names from a phone book, and students) and found no difference between groups.

METHOD

Participants

Participants were 251 students (100 in 1999, 151 in 2003)[19]; 114 were students enrolled in an auditing class (average number of accounting courses = 8.0) and 137 students enrolled in a beginning accounting class (average number of accounting class 1.7). Participants completed the study during the last 20 minutes of a class period, and were offered a small amount of extra credit for participating. Although students would still have received this extra credit if they decided not to participate, all present took part.

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[17] Robert J. MacCoun, "Experimental research on jury decision-making," Science, Vol. 244:4908 (June 2, 1989), 1046-1051, at 1046-1047

[18] Kathyrn Kadous, "Improving jurors' evaluations of auditors in audit negligence cases," Contemporary Accounting Research, Vol. 18:3 (Fall 2001), 425-444, at 431 and 441.

[19] Since the experiment was first run in 1999, the accounting industry has come under intense political and society scrutiny. The Enron, WorldCom and Arthur Andersen scandals, among others, and the subsequent passage of the far-reaching Sarbanes-Oxley Act has increased the salience of the auditors' role in the capital markets system. The study was conducted again in 2003, to see if the publicity surrounding the scandals and new legislation increased the salience of accounting misconduct, resulting in less favorable auditor judgments. Since there were no significant differences between years for any of the conditions, the data from the 2 years were combined. Results for each time period analyzed separately were essentially the same.

Materials

Each students received a packet that contained the IRB Review consent page, a two or three page audit litigation scenario, and a post-questionnaire with demographic and feedback questions.

The scenario, an elaboration of the case included in Jennings et al, [20] describes a litigation case brought by the Buchman Group, a group of stockholders, against the ABC audit firm that had issued a standard (favorable) audit opinion of Springlake Industries, stating that Springlake's financial statements were free of material misstatements. The Buchman Group claimed that they had relied upon the financial statements when purchasing the company's stock. When two errors (one an accounting error, one due to fraudulent statements by Springlake management) that together caused the statements to be materially misstated were subsequently discovered, the price of the stock fell, and the stockholders were suing for damages to the extent of the decline in stock price.

All scenarios were the same except for two paragraphs discussing the audit firm's audit structure methodology. The structure described was either a highly structured audit or an unstructured audit. In addition, since both plaintiff and defendant get to present the case from their respective viewpoints in a trial setting, each audit structure was framed both positively and negatively in the same case. The order of presentation was alternated so that primacy effects (the first impression effect) and recency effects (where the most recent evidence is the most salient when the decision is made soon after presentation of evidence[21] could be addressed. There was also a control scenario that did not have the two paragraphs on audit structure. A sample scenario is included in Appendix 1.

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[20] Jennings et al., at 123-125.

[21] Martin F. Kaplan and S. Schwartz, Human Judgment and Decision Processes in Applied Settings, (New York: Academic Press, Inc., 1977), at 37-38.

Design

The design is a 2 x 3 (between) x 2 (within) subjects design. Two groups (group 1 with an intermediate amount of accounting and auditing knowledge and group 2 with little or no accounting and auditing knowledge) were asked to rate the quality of the audit decision to issue an unqualified ("clean") audit opinion and indicate their assessment of the audit firm's liability. Subjects were randomly assigned to 3 audit levels (high audit structure, unstructured audit, no mention of audit structure). Nested within the high structure and unstructured audit manipulation was an order factor (whether the subject was presented with a favorable then unfavorable audit structure description or the unfavorable frame first). The subjects in the structure conditions were asked to make intermediate evaluations after reading the first paragraph on audit structure. Then they made a final evaluation of the quality of the auditor's decision and extent of liability after reading the second oppositely framed paragraph.

RESULTS AND DISCUSSION

Manipulation Checks

As part of the post-experimental questionnaire, subjects were asked to indicate the level of audit structure (0=unstructured to 10=highly structured), and the importance of that structure in their decision (0=not at all important to 10=the most important aspect). There was a significant difference between structure ratings for the levels of structure, indicating that the audit structure manipulation was successful. Overall, the high audit structure manipulation mean was 7.6, while the unstructured audit's mean was 3.9. The structure rating implied for the case where structure was not mentioned was 5.6. By group, all means were higher for the more knowledgeable subjects. The overall mean for importance of audit structure was 6.1. There were no significant differences for the importance of structure between groups or between structure levels (ratings ranged from a low of 5.1 to a high of 6.8)

In addition, subjects rated how realistic (and how understandable) the scenario was on a scale from 0=totally unrealistic (or not at all understandable) to 10=totally realistic (completely understandable.). Overall means were 7.9 (s.d. = 1.8) for realism and 7.3 (s.d. = 2.1) for understandability, suggesting that the subjects found the scenarios both realistic and understandable.

Test of Hypothesis One: Accounting/Auditing Knowledge Effects

Hypothesis one states that evaluations of the quality of the auditor's decision to issue an unqualified ("clean") opinion (and asssessments of audit firm liability) will be lower (higher) for juror surrogates with little or no accounting and auditing knowledge than for juror surrogates with an intermediate level of accounting and auditing knowledge. Results support this hypothesis. Table 1 contains descriptive statistics that show that the quality and liability ratings were consistently higher for the group with an intermediate level of accounting knowledge[22]. Table 2 shows the results of a 2 way ANOVA analysis. The effect of knowledge level is significant on the evaluations of the quality of the auditor's decision ($f=20.302$, $p < 0.001$). The same is true for the effect of knowledge level on the extent of liability ($f=24.727$, $p < 0.001$). In every condition, the quality of the auditor's decision to issue an unqualified ("clean") opinion was judged higher, and the extent of liability was judged lower by the more knowledgeable group of subjects.

In addition, the interaction between group and structure level was not significant for either the quality of audit analysis ($f = .791$, $p = .45$) and the extent of liability analysis ($f = .489$, $p = .61$)

[22] These analyses were done using the final judgments of auditors' decision quality and extent of auditor's liability. However, comparisons were also made using intermediate judgments. The results of these comparisons were essentially the same as those for final judgments, with the only exceptions noted in the discussions of interactions.

Test of Hypothesis Two: Audit Structure Level Effects

Hypothesis two states that evaluations of the quality of the auditor's decision to issue an unqualified ("clean") opinion and assessments of audit firm liability will be different for different levels of audit structure presented. However, there was no significant difference for level of structure on either evaluations of quality ($f = .396$, $p = .67$) or extent of liability ($f = .715$, $p=.49$). Since subjects were able to discern the level of audit structure, results seem to indicate that the moderate level of importance placed on structure per se is not enough to significantly influence their decisions.

A planned comparison of the judgment means for the high audit structure scenario with the unstructured audit scenario was run to see if one structure was perceived more favorably. Overall, there were no statistically significant differences. There was one interaction for which the unstructured audit structure was viewed more favorably than the highly structured audit. For auditing students reading a positive, then negative audit structure description, final judgments of the quality of the auditor's decision and auditor liability were significantly lower ($t = -2.2$, $p = .03$, and $t = -2.1$, $p = .04$ respectively) for the high audit structure scenario (mean = 5.21 and 5.23 respectively) , than for the unstructured audit scenario (mean = 6.60 and 6.90 respectively). This might suggest that more knowledgeable jurors might perceive an unstructured audit more positively, although this result was not seen for auditing students when decriptions went from negative to positive, nor for beginning students in any case.

Research Question One: Framing (Primacy And Recency)

Research question one proposes that a change in the framing (from negative to positive or positive to negative) of the audit structure descriptions will have an effect on evaluations and assessments. In a comparison of interim judments to subsequent judgments, no overall statistically significant differences were found for any group, or audit structure manipulation. However,

for the high audit structure manipulations that were described negatively, then postively, audit quality judgments significantly increased for each group of students. Mean beginning students quality assessments increased ($t = 2.8$, $p = .01$) from 3.64 to 4.91, and audit student mean assessments rose ($t = 2.4$, $p = .02$) from 6.3 to 6.86. No liability judgments were significantly affected, nor was the effect on the quality of the auditor's decision seen for the positive to negative frame or for either unstructured audit structure frame.

Threats To Validity

The brevity of the scenario might be a threat to external validity since actual court situations involve extensive amounts of evidence, expert testimony, etc. The emphasis on audit structure would be less compared to the greater amount of other information. However, the short length was deemed necessary for subject convenience, and to be able to focus on the issue of interest. The external validity threat due to the use of student subjects has been discussed earlier, but still exists.

Considering internal validity, the presence of intermediate judgments may impose an anchoring effect, where the subjects anchor on their first judgment instead of a neutral position. This may also limit external validity, since in an actual court setting, jurors are instructed to reserve judgment until all evidence is presented. However, some studies have shown that jurors form intermediate judgments anyway.[23] The intermediate judgment was retained in the experiment in order to further investigate the framing and order effects. Other internal validity issue might arise from the wording of the manipulations, so that the framing effects (positive and negative) might not be equally weighted, although the lengths of the descriptions were matched to address this concern. There are also other factors that affect juror decisions not addressed here that might affect internal validity if they are correlated with the independent variables. Prebeliefs are an issue

[23] Kaplan and Schwartz, at 44-45.

that is only partially controlled for here, by controlling the degree of knowledge.

CONCLUSIONS AND FUTURE RESEARCH

Results indicate that, to the extent tested here, accounting and auditing knowledge affects juror surrogates' audit evaluations and liability assessments favorably. While it is unlikely that a plaintiff would accept a Certified Public Accountant as a juror, further research might indicate if a moderate level of accounting knowledge is enough to enable the juror to make an educated decision without the pre-biases that more or less accounting-savvy candidates hold. Such knowledge would be of interest to both sides in an audit litigation setting. Another line of research might be to investigate whether tthe more auditor-favorable decisions made by more auditing participants was due to their knowledge level, or due to their intention to make auditing/accounting their chosen profession[24].

In addition, the lack of effect of a description of audit structure on juror judgments can be informative to audit firms. Results suggest that potential juror perceptual effects should not be a determinant for audit structure decisions. If there is a favorable effect of high audit structure in litigation settings, it is not due to the label itself, but perhaps due to the more extensive documentation such a structure provides.

As financial officers, corporate executives, and auditors are being held more accountable for the information they prepare,

[24] To investigate this issue, since the 2003 participants were asked to indicate their major, a comparison was made to determine whether accounting majors' judgments were more favorable than non-accounting majors' judgments. No comparison was possible for the auditing students, since all but 2 were accounting majors, but judgments for the 12 beginning accounting students who listed accounting as a major were compared to judgments of the 74 beginning students with other majors. None of the differences were statistically significant, although, surprisingly, all mean judgments were lower for the accounting majors, indicating that this might be an interesting area of inquiry.

publish and audit, more knowledge about the perceptions of potential jurors about the participant can be even more valuable. This study suggests that, although audit structure may not affect juror auditor quality and liability perceptions, a juror's level of accounting and auditing knowledge could potentially affect their auditor liability decisions.

TABLE 1: DESCRIPTIVE STATISTICS

Panel A: "Quality Of Audit" Mean Scores (Standard Deviations) [0-10, 0 = Poor, 10 = Very Good]

	Audit structure	*Level of Accounting Knowledge*			
		Gr 1 - intermediate		Gr 2- little or none	
Level of Audit Structure	High structure	6.0 (2.5)	n=47	5.0 (2.6)	n=51
	Unstructured	6.7 (2.0)	n=45	4.9 (2.5)	n=53
	No description	6.5 (2.0)	n= 22	5.0 (1.8)	n=33

Panel B: "Extent Of Liability" Mean Scores (Standard Deviations) [0-10; 0=Fully Liable, 10=Not Liable

		Level of Accounting Knowledge			
		Gr 1 - intermediate		Gr 2- little or none	
Level of Audit Structure	High structure	6.0 (3.0)	n=47	4.6 (2.6)	n=51
	Unstructured	6.8 (2.7)	n=45	4.6 (2.7)	n=53
	No description	6.6 (2.5)	n= 22	4.9 (1.9)	n=33

Panel C: Structure Level Perceptions And Importance: Mean Scores (Standard Deviations) [0-10 Scale]

		Level of Accounting Knowledge			
		Gr 1 - intermediate		Gr 2- little or none	
		structure/importance		*structure/importance*	
Level of Audit Structure	High structure	8.0 (1.9)	6.6(2.2)	6.6 (1.8)	6.7 (1.8)
	Unstructured	3.5 (2.4)	5.4 (2.4)	4.0 (2.3)	6.2 (1.9)
	No description	7.0 (1.6)	6.3(2.6)	4.9 (1.9)	6.5(2.1)

TABLE 2: RESULTS OF ANALYSIS

PANEL A: RESULTS FOR QUALITY OF AUDIT RATING

Source	*DF*	*MSE*	*F value*	*Probability*
Level of Accounting Knowledge	1	111.89	20.302	0.000
Structure Level	2	2.182	0.396	0.673
Accounting Knowledge * Structure	2	4.36	0.791	0.454

PANEL B: RESULTS FOR EXTENT OF LIABILITY RATING

Source	*DF*	*MSE*	*F value*	*Probability*
Level of Accounting Knowledge	1	61.11	24.727	0.000
Structure Level	2	17.06	0.715	0.490
Accounting Knowledge * Structure	2	4.33	0.489	0.614

Levels of Accounting Knowledge:
Group 1 (Moderate accting/audit knowledge)
Group 2 (Little or no accting/audit knowledge)

Structure Level
Level 1:High Audit Structure
Level 2: Unstructured Audit
Level 3: No Audit Structure Mentioned

APPENDIX 1: SAMPLE CASE: HIGHT AUDIT STRUCTURE

Springdale Industries is a medium size, publicly traded (AMEX) U.S. corporation founded in 1949. Springdale engages in the manufacture and wholesale distribution of plastic and ceramic tile products for commercial and residential construction. Currently, Springdale's independent auditor, ABC & Company, CPAs (a large national firm with offices in twenty-seven major U.S. cities) is being sued for failures in last year's audit of the financial statements issue in the Annual Report to Stockholders, the annual SEC (10K) filing, and in a March Stock Registration Filing and Prospectus. The financial statements and the audit report thereon, it is claimed, were deficient and misleading to the Buchman Group, plaintiffs in the case, who purchased at an allegedly excessive price the new Springfield stock issued following the March stock registration. Relevant summarized financial information follows:

INCOME STATEMENT		BALANCE SHEET	
Sales	$480,172,000	Cash & Securities	$13,236,000
Cost of Sales	(383,795,000)	Net Receivables	50,933,000
S G & A Exp	(36,471,000)	Inventory	74,075,000
Other Exp	(6,725,000)	Other Current Assets	3,336,000
Income Taxes	(23,923,000)	Long Term Assets	285,273,000
Net Income	29,258,000	Total Assets	426,853,000
		Accounts Payable	77,059,000
		Current Liabilities	9,900,000
		Long-Term Liability	124,973,000
		Stockholders Equity	214,921,000
		Total Liability & Equity	426,853,000

The alleged audit failure relates to overvalued inventory and non-recorded losses on the sale of long-term assets. Springdale's audited December 31 balance sheet listed $74 million in inventory. During the course of the annual audit ABC &

Company did not discover obsolete inventory of $3,050,000. ABC also did not uncover non-recorded losses on the sale (retirement) of long-term assets in the amount of $2,562,284). Consequently, reported income of $29,258,000 was overstated by 11% or $3,287,680 (i.e. an inventory error of $3,050,000 plus non-recorded losses on sales of long-term assets of $2,799,964, net of a 43.8% tax effect of $2,562,284). In the prior three years, Springdale reported strong growth in income of 12.7%, 8.9%, and currently 9.4%, based upon the reported (unadjusted) figures.

Management had been aware of the inventory overvaluation but, given their plans to issue new stock, had withheld the information from the auditors. They subsequently argued that, by itself, the income effect of the overvaluation did not significantly distort the financial statements. Management was apparently unaware of the errors relating to long-term assets. Each year the firm retires and/or replaces about 10% of its long-term assets. In this instance, errors occurred in the recording of five of the forty-three retirement/replacement transactions.

The Buchman Group has filed suit against the auditor for failing to detect these errors and for providing Springdale with an unqualified (i.e. "clean" opinion). The group further argues that their decision to purchase Springdale's stock was heavily influenced by the strong and continuing earnings trend reported in the audited statements. Adjustment for the above noted errors would significantly affect that trend. The group purchased 200,000 shares of new stock. Following purchase of the stock, the price fell $10 per share. Buchman attributes the decline to statement errors and their subsequent discovery and seeks damages of $2,000,000.

On the Springdale audit, ABC & Co conducted procedures including the development of materiality limits, and the substantive tests to detect errors in excess of these limits. The non-recorded losses were within the appropriate materiality limits. According to generally accepted auditing standards, auditors can only be expected to reasonably detect fraud, and while the program

is normally efficient in this regard, it was not able to overcome the complicity of management in this instance.

The Buchman Group claims that the auditor used a "canned" audit program, which utilizes the same procedures for any and all audits, regardless of the complexities, or lack of them, within a client firm. The structure does not allow for the customization of procedures to meet the unique individual situations and risks presented by each individual client firm. If the auditor's had taken into account the unusual circumstance of the approaching new stock issue for this particular firm, they might have detected the fraud.

QUESTIONS: Make a slash on the 0-10 scale to indicate your answer.

How would you rate the overall quality of the auditor's decision to issue an unqualified "clean" opinion on Springdale's financial statements?

Poor 0….1….2….3…..4….5….6….7….8….9….10 Very Good

To what extent do you think the audit firm should be held liable for the damages claimed by the Buchman Group?

Liable 0….1….2….3…..4….5….6….7….8….9….10 Not liable
for the for any
full amount damages

Do not continue to the next page until you have marked your answer to the questions above.

On the other hand, ABC & Co, the audit firm asserts that its audit program is a highly structured audit procedure, adhering to a prescribed logical sequence of procedures, and follows a comprehensive and integrated set of audit policies and tools that assisted them in completing every step of their audit in a thorough and objective manner. Because of its objectivity, there is little opportunity for an individual client to influence the extent or type of testing or the interpretation of the procedures' results. Based on the information they had available at the time of the audit and the objectively determined results of their carefully structured audit procedure, ABC & Co. claims their favorable report was the only appropriate conclusion they could make.

QUESTIONS: Make a slash on the 0-10 scale to indicate your answer.

How would you rate the overall quality of the auditor's decision to issue an unqualified "clean" opinion on Springdale's financial statements?

Poor 0….1….2….3…..4….5….6….7….8….9….10 Very Good

To what extent do you think the audit firm should be held liable for the damages claimed by the Buchman Group?

Liable 0….1….2….3…..4….5….6….7….8….9….10 Not liable
for the for any
full amount damages

POST QUESTIONNAIRE: Please answer the following questions, which will only be used for purposes relating to the interpretation of the results of this experiment. Please circle the closest answer

1. Age under 25 25-39 40-55 over 55

2. Gender Male Female

3. Marital status Married Single

5. Number of Accounting Courses, including this one.
1 2 3 4 5 6 7 8 over 8

6. Prior civil jury experience Yes No

7. Do you, or have you ever, invested in the stock market? Y No

8. How well did you understand the scenario?
Not at all 0….1….2….3…..4….5….6….7….8….9….10perfectly

9. How realistic did this scenario seem?
Totally Totally
unrealistic 0….1….2….3…..4….5….6….7….8….9….10 realistic

10. What type of audit procedure did the audit firm follow?
Unstructured Highly structured
0….1….2….3…..4….5….6….7….8….9….10

11. How important was audit structure in your audit quality rating decision?
Not important at all The most important aspect
0….1….2….3…..4….5….6….7….8….9….10