

The Effects of Type of Accounting Standard and Outcome Knowledge on Juror Evaluations of Auditor Responsibility

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Abstract: Jurors, in their evaluations of auditor responsibility, may inappropriately use information obtained after the questionable event has occurred (outcome knowledge) and may also negate the auditor's reliance on auditing standards. We investigate whether this event occurs if the auditor relies on a proper application of an accounting standard, which unlike auditing standards may be based more upon principles that are subject to interpretation.

We conduct a controlled experiment with 182 prospective jurors from a county circuit court. Participants are provided a case scenario involving the accounting for a lease transaction, manipulated at two levels: (a) principles-based accounting standard, and (b) rules-based accounting standard. The outcome knowledge is manipulated at three levels: (a) no outcome information, (b) moderately negative outcome information, and (c) severe negative outcome information. Results from the experiment suggest that jurors evaluate auditors more negatively when auditors rely on a principles-based, accounting standard. Further, we find the severity of outcome knowledge to influence the juror's evaluation of auditor responsibility. The type of accounting standard and the state of outcome knowledge do not interact to produce more negative evaluations of auditor responsibility. These results contribute to the discussion of increasing principles-based accounting standards in the North American litigious environment.

I. Introduction

Prior research suggests that jurors, rendering verdicts in audit litigation cases, may inappropriately use information obtained after the questionable event has occurred in their evaluations of auditor responsibility. This work also suggests that auditor reliance on the proper application of auditing standards does not always result in a favorable evaluation of auditor responsibility (Kadous, 2000). Like auditing standards, accounting standards may be based more upon “bright-line” rules or differently, more upon principles that are subject to interpretation. In this study, we examine the effects of type of accounting standard (rules-based versus principles-based) and the state of outcome knowledge on juror evaluations of auditor responsibility.

The rise in litigation concerned public accounting firms before and after the Sarbanes-Oxley Act of 2002 and the fall of Arthur Andersen. In 1992 the Chairmen of the Big Six accounting firms issued a statement calling for tort reform to stem the tide of meritless claims and coerced settlements that have plagued the profession (Arthur Andersen & Co. et al., 1992). Because of an estimated \$30 billion in claims against auditors, the profession was forced to limit audits of high risk business, experiencing difficulty in recruitment and retention, and facing prohibitively expensive insurance premiums (Arthur Andersen & Co. et al.).

Because audit litigation research focused on the auditor’s responsibility when reliance is placed upon more principles-based generally accepted auditing standards (GAAS), one solution would be the proposed change to more principles-based accounting standards, but this is also argued to increase the potential legal liability. One response is from the source of accounting standards, the Financial Accounting Standards Board (whose rulings are still subject to approval from the SEC’s Public Company Oversight Board) which argues:

Preparers and auditors would need to apply professional judgment in more circumstances, while the SEC, investors, creditors, and other users of financial information must accept the consequences of applying professional judgment, including some divergence in practice. Concerns about SEC enforcement actions and related litigation matters are significant, potentially affecting the extent to which preparers and auditors would be willing to apply professional judgment in more circumstances (Financial Accounting Standards Board, 2002, p. 9).

Principles-based standards require the application of professional judgment, and the potential to have that judgment successfully challenged in court.

Another court-related issue that confounds this question is the outcome effect, the use by jurors of post-event (post-audit) knowledge (e.g., Latham & Linville, 1998), which is also common in cases involving medical decisions, capital budgeting, and military situations (Hawkins & Hastie, 1990). Prior research suggests mixed results on the severity of the outcome information. Some studies find no significant differences in attributions as outcomes increase in severity (Jennings, Kneer, & Reckers, 1993). Others find that more severe outcomes result in greater attributions of responsibility (Kadous, 2000).

To investigate these issues we conducted an experiment, consistent with prior research, where jurors are provided audit litigation case scenarios manipulated for the type of standard and outcome effects.

The rest of this paper is organized as follows. In Section II we review the pertinent literature and develop hypotheses. In Section III we describe the method used to test our hypotheses. In Section IV we report our results, followed by Section V in which we discuss our findings and limitations.

II. Hypotheses Development

The Effect of the Standard

When auditors issue a standard, unqualified opinion, they are reporting to external users that the financial statements are presented in accordance with Generally Accepted Accounting Principles (GAAP). An overt material violation of a rules-based accounting standard would likely result in legal sanctions. This end result is not so certain when the alleged violation involves a principles-based accounting standard. Following the rules should result in exoneration, while following principles may or may not result in a successful outcome for the auditor.

Rules provide actors (auditors) with ex ante guidance that encourages them to behave in a manner that avoids legal sanctions. Principles, applied with ex ante judgment, may provide plaintiffs' lawyers the opportunity to challenge those judgments after outcomes are known. Rules provide a measure of protection, while principles create legal uncertainty (Kaplow, 1999).

When a plaintiff initiates a lawsuit against the auditors, the claim is usually one of negligence. In order to prove negligence, four elements are necessary: 1) the auditor has a duty of care, 2) the auditor breached that duty, 3) the plaintiff suffered a loss, and 4) the auditor's breach of duty was the proximate cause of the plaintiff's loss (Causey, Jr. & Causey, 1991). That the auditor has a duty of care and the plaintiff suffered a loss are usually not at issue in a negligence lawsuit. Plaintiff's attorneys will argue that the audit was sub-standard (breach of duty), and the sub-standard audit caused the plaintiff's losses (proximate cause). Defense attorneys will argue that the audit was conducted in accordance with GAAS and therefore, there was no breach of duty.

When the claim of negligence centers on breach of duty, research suggests that the standards, followed by the auditors, tend to become moving targets in the eyes of the jurors (Kadous, 2000). This creates a situation where adherence to standards does not necessarily relieve the auditor from liability. When the thrust of the case centers on causality, research suggests that negligence cases may still move forward when causality is in doubt (Cloyd, Frederickson, & Hill, 1996). The negligence rule creates further legal uncertainty for auditors and other professionals facing negligence lawsuits (Kaplow, 1999).

In the scenario posed in this article, auditors are facing a negligence lawsuit involving the application of an accounting standard, rather than auditing standards. The opinion

paragraph, in the standard audit report, states that the financial statements are presented in accordance with GAAP. A departure from a rules-based accounting standard would not be defensible in a lawsuit. However, a departure from a principles-based standard would be a fact pattern decided by a judge or jury. Jurors have shown the propensity to shift auditing standards, i.e. expect higher standards, when outcomes are known (Kadous, 2000).

According to Weiner (1979), people assign internal or external attributions to observed events. The use of internal attributions assign responsibility to the person and use of external attributions assign responsibility to outside forces. Weiner further hypothesizes that controllable or uncontrollable factors affect causal attributions. In the presence of controllable factors, the observer assigns responsibility to the person, while in the presence of uncontrollable factors, the observer assigns responsibility to external forces. Finally, Weiner suggests that stable factors result in personal attributions and unstable factors result in external attributions. Each of Weiner's broad dimensions, locus (internal or external), controllability, and stability, results in specific attributions. Internal locus, controllable and stable factors result in causal attributions toward the actor (Weiner, 1979).

Using Weiner's dimensions, reliance on principles-based accounting standards may result in more internal attributions. The auditor is perceived as a professional, with specific skills and knowledge, and may therefore be held more responsible for his or her decisions. Reliance on rules-based standards may result in more external attributions. The auditor is bound by the rules and is therefore likely to be perceived as less responsible.

Auditors have more control over decisions when standards are principles-based. They have more latitude in the application of principles, and may be held more personally accountable for the results. Weiner's (1973) controllability dimension suggests that controllable events result in causal attributions. Further, Tan & Lipe (1997) find that controllability matters when outcomes are negative.

Stability relates to the causes of events. Stable factors result in causal attribution. Auditors, performing a function that they are well trained for, in an environment that they are familiar with, presents a perceived stable environment.

Kelley (1973) explained causal attributions by defining the characteristics of consistency, distinctiveness, and consensus information. Based upon the stimulus (behavioral event), does the actor always respond in this manner (consistency)? Do other events result in the same response (distinctiveness)? Do others, given the same stimulus, react similarly (consensus) (Kelley, 1973)?

Using Kelley's framework, and adapting the behavioral characteristics to an audit litigation scenario, researchers find that business owners attribute more responsibility to auditors for unfavorable outcomes than do CPAs (Arrington, Bailey, & Hopwood, 1985). Consensus information is operationalized as the auditors' adherence to auditing standards. Distinctiveness information is based upon the audit task (routine or not). Consistency is operationalized as a performance measure based upon the auditor's record of prior litigation.

Further results suggest that attributions are determined in accordance with Kelley's hypothesized relationships (Arrington et al.).

Therefore, using Weiner's (1979) and Kelley's (1973) dimensions, we suggest that juror evaluations of auditor responsibility will be less favorable when the auditor places reliance on a principles-based, versus a rules-based accounting standard.

This suggests the following hypothesis:

H₁: Jurors will evaluate auditors less favorably when auditors rely on a principles-based, versus a rules-based, accounting standard.

Outcome Effects

Hawkins and Hastie (1990) conclude that research into hindsight effects can extend to decision making, or evaluative judgments. People with outcome information will evaluate decision makers more harshly when the outcome is unfavorable. The evaluators assume that the outcome was more predictable, given the chain of events, and they therefore find that the decision-maker should have been able to foresee and avoid the unfavorable outcome (Lowe & Reckers, 1994).

In an audit litigation setting, jurors must decide in hindsight, what the auditors should have known or done in foresight, to avoid a negative outcome. Will jurors use the negative outcome information to judge the auditors more harshly? Research suggests that the answer to this question is yes. While the judicial system is well aware of the effects of hindsight bias and outcome effects, the ability to stem the bias in professional liability cases is limited (Rachlinski, 1998).

Litigation against auditors typically arises when the auditors issue an unqualified opinion on financial statements that are later found to be materially misstated (Latham & Linville, 1998). In addition, management fraud, involving fictitious transactions or events, and bankruptcy or significant client losses, are factors also associated with auditor litigation (Latham & Linville; Loebbecke, Eining, & Willingham, 1989). When a firm fails or suffers significant losses, those individuals who have been harmed will typically initiate an error search of the financial statements (St. Pierre & Anderson, 1984). The finding of a significant error typically results in a lawsuit against the auditor. Potential errors include GAAS and generally accepted accounting principles (GAAP) interpretations and a failure to disclose material matters (St. Pierre & Anderson; Dye, 1993). GAAP errors, found in an evaluation of audit litigation cases center on, revenue recognition, asset valuation, and capitalization versus expensing (St. Pierre & Anderson). The case scenarios depicted in this experiment involve the capitalization versus the expensing of lease obligations.

In audit litigation, outcomes are not always legally relevant. Jurors are expected to make judgments about the auditor's behavior prior to the negative outcome. If the auditors follow Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS) in conducting the audit, they should not be found liable, regardless of the final outcome. Research suggests that jurors are unable to separate the outcome information

from evaluations of auditor liability (Paetzold & Huss, 1993). In our experiment, participants are cautioned, in both the instruction letter and the questionnaire, to ignore the outcomes in their evaluations of auditor responsibility.

Prior research finds that outcomes influence jurors in an inappropriate manner. Outcome knowledge, that is not legally relevant in the evaluations of decision makers, is shown to influence jurors (Paetzold & Huss, 1993). Given a similar fact pattern, non-auditors attribute more responsibility for audit failure to the auditors, than do CPAs (Arrington, Hillison, & Williams, 1983). Outcomes of an illegal police search influence jurors in their awarding of compensatory and punitive damages (Casper, Benedict, & Perry, 1989). When the outcome of the police search results in more damaging evidence, compensatory and punitive damages are greater (Casper et al., 1989). Outcome knowledge is shown to influence judges' evaluations of auditor responsibility in the direction of the outcome (Anderson, Lowe, & Reckers, 1993). The perceived foreseeability of the outcome influences judges such that evaluations of auditors are lower when the outcome is more foreseeable (Jennings, Lowe, & Reckers, 1998).

Audit partners are often called upon to judge the work of other auditors in the peer review process. In an experiment, 123 audit partners from Big 5 firms were asked to evaluate the work of their peers. Outcome knowledge was manipulated at three levels, negative, positive, and no outcome knowledge. Results suggest that negative outcome information results in lower probability assessments, and lower evaluations of the auditor (Emby, Gelardi & Lowe, 2002). This research also suggests that even audit partners, who know that they should be evaluating their peers from an ex ante perspective, also fall victim to hindsight bias and outcome effects (Emby et al.). Hence we hypothesize,

H₂: Jurors with knowledge of a negative outcome will evaluate auditors less favorably than will jurors with no outcome knowledge.

Severity of the Outcome

Outcome knowledge affects evaluations of decision-makers. Negative outcome information results in more negative evaluations, while the opposite is true for positive outcomes. Results are mixed when negative outcome information increases in severity.

In an early example of attribution of responsibility, Walster (1966) finds that more severe outcomes result in greater responsibility assigned to the decision-maker. In Walster's experiment, the decision-maker takes reasonable precautions in parking a vehicle on a hill. Several scenarios are presented, with varying outcomes. In the more serious outcome scenarios, participants attribute greater responsibility to the decision-maker for those severe outcomes (Walster, 1966).

Walster (1966) finds that a more severe negative outcome results in more negative attributions of responsibility. These same results are not replicated in a later study (Walster, 1967). Jennings, Kneer, & Reckers (1993) find no difference in auditor liability when outcomes are severe. When outcomes are moderately severe, auditors providing higher

standard of care are judged less negatively (Kadous, 2000). However, when outcomes are severe, the higher standard of care has insignificant effect on juror evaluations of auditor responsibility (Kadous, 2000).

Finally, the question arises on whether the combined effect of outcome knowledge will be uniquely increased (i.e. will interact) when auditors use a principles-based accounting standard.

H₃: Jurors will evaluate auditors even less favorably when auditors rely on a principles-based standards when severe outcome knowledge is present than when these factors are considered separately.

III. Research Method

Participants

The venue for the research study is a circuit court in Central West Virginia. The Court selects jurors from a geographical area encompassing the city and surrounding county. Jurors are randomly selected to serve in the jury pool for a one-month period. Jury pools of eighty to ninety participants are called to orientation on the second Monday of each month. Subjects in this study are drawn from the pool of remaining jurors, after orientation and the day's actual jury, if any, is seated. The remaining jurors are asked to remain in the courtroom, where the experiment is conducted.

192 volunteers were recruited for this study. The experiment took place over five months, with groups of 25 to 50 participants on orientation day, each month. The juror demographic profile is displayed in Table 1. This data was compared with selected information provided to the Circuit Court from juror qualification reports. The average age of qualified jurors is 49. This compares favorably with the average age of participants (44.16 years). The gender breakdown, from the qualification report is 47.3% male and 52.7% female. This compares with 37% male and 63% female for the research study. The juror qualification report represents the results of the total county-wide pool of potential jurors who are subject to jury service for the year. Gender breakdown of any individual juror orientation pool may not reflect the qualification report averages. Gender data was not collected for the orientation pool prior to asking for volunteers for the study, so no further comparisons were undertaken. Questions also asked whether the juror was an auditor, a CPA, stockholder, attorney or property owner.

Task

Upon conclusion of orientation and panel selection, if any, the remaining jurors were asked to participate in a juror decision-making experiment. In order to achieve maximum participation, subjects were offered nominal remuneration of \$5 for their time. Participants were told that the experiment would require approximately twenty minutes. Each participant was given a packet containing an instruction letter, case materials, and a questionnaire. The case materials depict a scenario in which company management must decide the proper accounting treatment for a transaction involving leased equipment. During the audit of the financial statements, the auditors evaluate the lease transaction, and concur with management's handling of the lease. In each of the scenarios the leases were accounted for as operating leases. The stockholders file a lawsuit, claiming that the financial statements are misleading, due to the accounting for the lease transaction.

Independent Variables

Type of Standard

Participants received one of six possible case scenarios, a two by three factorial. Factor A, type of accounting standard, is manipulated at two levels: a principles-based accounting standard, and a rules-based accounting standard. The case materials, provided to participants, includes a scenario involving the capitalization, verses the expensing, of leased assets. For those participants receiving a rules-based standard, the "bright-line" rules of Standard No.13 are provided as the guidelines that management and the auditors followed in the preparation of the financial statements. For those participants receiving a principles-based standard, the "bright-line" rules of Standard No. 13 are changed to reflect a principles-based standard. For example, the current FASB Standard No. 13 provides "bright-line" measures, or rules, for lease capitalization (FASB, 1976). Standard No. 13 states that a lease must be capitalized if the lease term is equal to 75% or more of the economic life of the leased asset (a "bright-line rule). A more principles-based approach stipulates that capitalization must occur if the lease term includes most of the economic life of the asset (Nelson, 2003).

Type of Outcome

The second independent variable in this experiment, outcome knowledge (factor B) is manipulated at three levels: no outcome knowledge, moderately negative outcome knowledge, and severe negative outcome knowledge. Moderate negative outcome knowledge is conceptually in between no knowledge and severe negative outcome knowledge. In the case scenario, participants are provided a brief statement of outcomes to the client's business. For the control group, no outcome information is provided. Moderately negative outcomes and severe negative outcomes follow Kadous (2000). Moderately negative outcome is operationalized as large losses suffered by creditors, but the company is expected to recover (Kadous, 2000). Severe negative outcome is operationalized as large losses suffered by creditors, client company bankruptcy, and subsequent loss of jobs (Kadous).

The Dependent Variable

Participants are asked three questions, each scored from 0 to 9. Each score is then summed to represent values (0 to 27) of the dependent variable.ⁱ

These questions can be found in Appendix A: (1) Do you feel that the auditors made the correct decision in concluding that the lease should be accounted for as an operating lease (the correct decision=0 and the incorrect decision=9)? (2) How competent did you perceive the auditors to be in performing their duties in the audit of PEP (completely competent = 0; completely incompetent = 9)? (3) To what extent do you believe that stockholders must assume normal investment risks when purchasing stock, and therefore are largely responsible for their own losses (responsible = 0; not responsible = 9)?

IV. Results

Manipulation Checks

Manipulation checks for the independent measures were included in the questionnaire. For the outcome knowledge manipulation, participants were asked to identify the outcome of their case: (a) a lawsuit has not been filed yet, (b) the company experienced some difficulty, but was expected to recover, and (c) the company filed for bankruptcy and employees lost their jobs. These responses were compared to the actual known state listed as “no outcome,” “moderately negative outcome,” and “severe negative outcome” conditions. Of the useable responses, 81.3% of the participants correctly identified their respective outcome. Of those participants who incorrectly identified their respective case, 59% were from the no outcome condition. These individuals may have assumed an outcome since they were being asked to render an opinion in the case.

For the principles/rules manipulation, participants were asked to categorize the accounting guidelines as either “more like principles,” or “more like rules,” on a continuous scale from 0 to 9. The mean response for participants receiving a case based on principles was 4.75 and for those receiving a rules-based case scenario on principles, 5.05, and are not statistically different. One possible explanation for the failure of this manipulation is participants’ understanding of the terms. Further, the continuous scale may have added to the confusion.

Finally, participants were asked if they understood the case materials and instructions. Five participants answered this question in the negative and were dropped from the analysis.

Homogeneity of Jurors

Table 1 presents the average of the demographic juror data collected on five separate days over a five-month period. Participants were surveyed at the conclusion of their juror orientation which took place on the second Monday of each month. The demographic means (by one-way ANOVA) or percentages (by Chi-Square) for each one of the five groups were compared to insure that the groups were homogeneous. Results are presented in Table 2.

The only statistically significant variable is Stockholder (with p-value, 0.0428). This Chi-square analysis indicates that participants are less likely to be stockholders on the January and March collection days, but otherwise the groups can be considered somewhat homogeneous.ⁱⁱ

Tests of Hypotheses

Table 3 represents the analyses for the full set of useable responses, with the summated scale as the dependent measure, representing the juror evaluations of auditor responsibility. (N=182).

Table 3

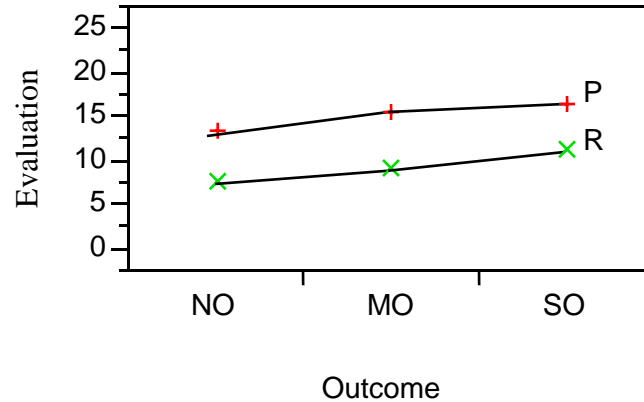
Cell Means (St Dev) for Type of Accounting Standard by Outcome Knowledge

			Factor B		
			Outcome Knowledge		
Factor A			No Information	Moderate	Severe
Type of Accounting Standard	Rules- based	M	7.42	9.00	11.03
		SD	(6.27)	(6.65)	(7.28)
	n	31	30	32	
	Principles- based	M	13.52	15.66	16.37
SD		(6.81)	(5.85)	(5.90)	
n		27	32	30	

The Test of Interaction, H₃

Figure 1 shows the means plot for cell means in Table 3, and the main effects and two-way interactions for Table 4. The nearly parallel lines in Figure 3 are indicative of no interaction between type of accounting standard, outcome, and juror evaluations of auditor responsibility. These same results are also reflected in Table 4 (A by B interaction). With $F = .1622$; $p < .8504$, Interaction (H₃) is not supported.

Figure 1
LS Means Plot



In Figure 1 above, NO represents the no outcome information provided, MO is moderately negative outcome knowledge, and SO is severe negative outcome knowledge. The vertical axis represents the results of the summated scale indicating the evaluation of auditor responsibility. It was expected that evaluations of auditor responsibility would increase with the severity of the outcome and would be greater when reliance was placed upon a principles-based accounting standard. In other words, the slope of the principles line (P) would be rise significantly upward to the right when compared with the rules (R) line. Since this was not the result, the principles versus rules distinction may not have been clear to participants. Furthermore, the conceptual distance between the levels of outcome information may not have been significantly sufficient to result in an interaction.

Table 4: ANOVA Summary

Relationship between type of accounting standard, outcome knowledge, and juror evaluation of auditor responsibility

Source	df	SS	MS	F	R ²
Principles/Rules (A)	1	1649.07	1649.07	39.31*	.176
Outcome (B)	2	313.15	156.57	3.73**	.033
A by B Interaction	2	13.61	6.81	.16	.001
Within Groups	176	7383.44			
Total	181	9392.29			

Note: N= 182; *p< .0001; **p< .05

The Test of Main Effects: H₁, H₂

In the absence of interaction effects, the analysis is directed towards any main effects (H₁ and H₂).

H₁--that jurors will evaluate auditors less favorably when the auditors rely on a principles-based, versus a rules-based, accounting standard

We find evidence to support H1 from Table 4 and Figure 2. First, in Table 4, H₁ is supported (F= 39.3092; p< .0001): there is evidence of a difference in the cell means. This is also shown by the t test in Figure 2 (15.1 v. 9.1, where principles-based decisions receive more responsibility).

Figure 2

LSMeans Differences Student's t

Level		Least Sq Mean
P	A	15.180478
R	B	9.150202

Levels not connected by same letter are significantly different

H₂--that jurors with knowledge of a negative outcome will evaluate auditors less favorably than jurors with no outcome knowledge

We find evidence to support H2 from Table 4 and Figure 3.

From Table 4 (ANOVA Summary) the main effect of outcome knowledge was significant (F=3.7323; p<.0259). The results of the t-test are displayed in Figure 3. The levels of the main effect that are significantly different are at the extreme (no outcome information (NO), and severe negative outcome information (SO)). There is no significant difference with either extreme compared with the moderate negative outcome information (MO) middle condition.

Figure 3

LS Means Differences Student's t

Level		Least Sq Mean
SO	A	13.698958
MO	A B	12.328125
NO	B	10.468937

Levels not connected by same letter are significantly different

V. Conclusions

Findings

We find as do others, an outcome effect, but more importantly the influence of standard effect and not interaction of these on juror decisions.

The use of a principle-based standard

The use of a principle-based standard resulted in more negative evaluations of the auditors. As the FASB (2002) indicated in their proposal memorandum, the need to apply more professional judgment in the application of principles-based accounting standards may cause

concern among preparers and auditors that their professional judgment might be challenged in litigation. These research findings support that concern. Lawton and Parker (2002) found that doctors were less negatively evaluated when they followed practice guidelines (i.e. rules). While overtly breaking a rule would not be defensible in court, following the rules appears to provide auditors with a less negative evaluation than following a principle.

The outcome effect

As was the case in a Kadous (2000), we find a severe negative outcome resulted in more negative evaluations of auditor responsibility. Prior research studies have suggested that negative outcomes result in more negative evaluations of auditor responsibility (Jennings, Kneer & Reckers, 1993; Anderson, Lowe & Reckers, 1993; Lowe & Reckers, 1994). This experiment lends support to the notion that the severity of the consequences influences juror evaluations of auditor responsibility. Also, the conceptual distance between levels of outcome information may not have been great enough to result in an interaction effect with the standard applied. Further, jurors were not asked to establish damage awards, and no information was provided to give participants a sense of the dollar losses associated with the outcomes. A measure of the damage awards may have acted as a better indicator of the effect of outcome knowledge on the juror evaluation. Prior studies have relied on a deviation from Generally Accepted Auditing Standards. The jurors' decisions were based upon whether or not the standards were properly applied. In this study the accounting rules were properly applied.

Limitations of the Study

This study has several limitations. First, information provided to jurors was limited to a written case scenario. Jurors were told in both the letter of instruction and the questionnaire to base their decisions only on information provided in the case prior to the outcome. These findings suggest that jurors may inappropriately use outcome knowledge in their evaluations of auditor responsibility. Once again, as Hawkins and Hastie (1993) suggest, jurors are likely to be unaware of the information that should be disregarded and further, they are unable to ignore its effects.

In actual litigation the jurors would have heard attorneys' opening and closing statements, witness testimony, and the judge's instructions. In addition, the materials provided to jurors were presented as factual and pertinent to the case. Discovery and other evidentiary procedures may have challenged this assumption in a court of law. Second, responses were sought from individual participants in what would normally be a group decision-making process. While first ballots capture the majority of final jury decisions, it is not known how a case, such as the one described in this research, would ultimately be decided by a jury.

Another limitation of this study is the position of the outcome information in the case scenarios. Participants were informed of the outcome at the end of the case scenario. This was the last piece of information prior to completing the questionnaire. This placement may have contributed to the outcome effects. In an actual court setting, the jurors might expect to hear about outcomes during voir dire or from judges' and attorneys' opening statements.

Finally, this research investigated one rules-based accounting standard and made assumptions about the wording of a more principles-based version of that standard. The FASB may establish principles-based wording and guidance that varies significantly from the wording used in this research.

Future Implications

Results from this research do have implications for practitioners. Jurors did assign more responsibility to the auditors when reliance was placed upon the application of a more principles-based accounting standard. Following a rules-based standard apparently provided some protection in the assignment of responsibility.

Suggestions for future research might include a similar study utilizing a more realistic courtroom experience. Participants could be provided more extensive materials to include opening and closing arguments, witness testimony, and the judge's instructions. Further research should also be directed toward other more rules-based accounting standards such as revenue and expense recognition and the accounting for pensions and other post-retirement benefits.

Table 1
Demographic Information for Jurors

<u>Panel A. Continuous Measures:</u>					
Variable Description	N	Min	Max	Mean	Std. Dev.
Age	182	20	73	44.16	11.73
Income	169	0	\$250,000	\$40,516	\$36,645
Education	178	6	20	14.58	2.37
<u>Panel B. Discrete Measures:</u>					
Variable Description	Level	N	%		
Gender	Male	67	37		
	Female	115	63		
Marital Status	Married	126	69		
	Single	56	31		
Employment	Employed	141	77		
	Unemployed	18	10		
	Retired	23	13		
CPA	Yes	1	1		
	No	181	99		
Auditor	Yes	2	1		
	No	180	99		
Stockholder	Yes	73	40		
	No	109	60		
Attorney	Yes	4	2		
	No	178	98		
Property Owner	Yes	138	76		
	No	44	24		

Table 2
Homogeneity of Juror Groups

Variable Description	Test	Significance Level
Age	ANOVA	.1454
Income	ANOVA	.3374
Education	ANOVA	.3567
Gender (Male, Female)	Chi-Square	.1393
Marital Status (Married, Single)	Chi-Square	.6974
Employment (Employed, Unemployed, Retired)	Chi-Square	.8708
CPA (Yes, No)	Chi-Square	.3766
Auditor (Yes, No)	Chi-Square	.0751
Stockholder (Yes, No)	Chi-Square	.0428
Attorney (Yes, No)	Chi-Square	.2076
Property Owner (Yes, No)	Chi-Square	.8133

Appendix
Type of Accounting Standard and Outcome Manipulations
 (from case scenarios)

Panel A: Rules-based Accounting Standard

Guidelines followed by accountants and auditors, for the proper accounting for leases, are as follows:

If the lease transfers substantially all of the benefits and risks of ownership of the property (equipment), then the company should recognize the liability (debt) on its balance sheet.

Two rules are important in determining how PEP should properly account for the leased equipment.

1. Is the lease term equal to 75% or more of the economic life of the asset (equipment)? For example, if you lease an asset for seven years, and the asset has a useful life (economic life) of ten years, then you are leasing the asset for 70% of its economic life. Does this seven-year term include 75% or more of the economic life of the leased asset?

2. Is the present value of the minimum lease payments equal to 90% or more of the fair market value of the leased asset (equipment)? For example, if an asset has a fair market value of \$10,000, and you agree to make lease payments that have a current value of \$8,800, then your payments are equal to 88% of the fair market value. Is this \$8,800 equal to 90% or more of the fair market value of the leased asset?

Panel B: Principles-based Accounting Standard

Guidelines followed by accountants and auditors, for the proper accounting for leases, are as follows:

If the lease transfers substantially all of the benefits and risks of ownership of the property (equipment), then the company should recognize the liability (debt) on its balance sheet.

To provide further help, the following questions should be answered:

1. Does the lease term include most of the useful life of the leased asset (equipment)? For example, if you lease the equipment for seven years, and the equipment has a useful life of ten years, then you are leasing the equipment for 70% of its useful life. Does this seven year term include most of the useful life of the leased equipment?

2. Does the present value of the lease payments include most of the fair market value of the leased asset (equipment)? For example, if the equipment has a fair market value of \$10,000, and you agree to make lease payments that have a current value of \$8,800, then your payments are equal to 88% of the fair market value. Does this \$8,800 include most of the fair market value of the leased asset?

Panel C: No Outcome Information

Lawsuits usually occur when someone has suffered a loss, and the loss is a result of someone else's actions or decisions. You are being asked to reach a decision in a new, experimental, case in which a lawsuit has not yet been filed. In the case just presented to you, some potential plaintiffs (stockholders, creditors, employees) may or may not suffer losses, and therefore, may or may not file lawsuits. In this new and experimental court case, you are asked to make a

decision without any knowledge of the potential outcome. You are asked to consider only the decisions that the auditors made in this case. Your decision now will help the potential plaintiffs and defendants to decide their future actions.

Panel D: Moderately Negative Outcome Information

Because of the stockholders lawsuit, several creditors called their loans. PEP was unable to pay the creditors. As a result, the creditors sustained large losses. While the present situation looks bleak, PEP is expected to eventually recover.

Panel E: Severe Negative Outcome Information

Because of the stockholders' lawsuit, several creditors called their loans. PEP could not pay. As a result, PEP declared bankruptcy in late 2003. Stockholders and creditors suffered large losses, and many employees lost their jobs.

Panel F: Dependent Variable Questionnaire Items

1. Do you feel that the auditors made the correct decision in concluding that the lease should be accounted for as an operating lease? (Circle a number)

Correct
decision 0 1 2 3 4 5 6 7 8 9 Incorrect decision

2. How competent did you perceive the auditors to be in performing their duties in the audit of PEP? (Circle a number)

Completely
competent 0 1 2 3 4 5 6 7 8 9 Completely incompetent

3. To what extent do you believe that stockholders must assume normal investment risks when purchasing stock, and therefore are largely responsible for their own losses? (Circle a number)

Responsible 0 1 2 3 4 5 6 7 8 9 Not responsible

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ⁱ Reliability of the scale was determined with a Cronbach's alpha of .7445.

ⁱⁱ A one-way ANOVA (test of means) was conducted with stock ownership as the predictor variable, and the evaluation of auditor responsibility (sum) as the dependent measure. Results were not significant.