

**Perspective Taking Ability and Performance in an Audit Committee Member Task:
Experimental Evidence**

Ong-Ard Singtokul
800 West Peachtree Street
College of Management
Georgia Institute of Technology
Atlanta, GA 30338-0520
ong-ard.singtokul@mgt.gatech.edu
404.894.9474

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Ong-Ard Singtokul

Georgia Institute of Technology

ABSTRACT: To improve audit committee performance in guarding against management fraud, regulators and major stock exchanges established the concept of financial expertise, which requires certain knowledge and experience related to auditing and financial reporting. This study sheds light on how audit committee members' prior experience can affect their task performance through the theory of perspective taking. I conduct an experiment to investigate the effect of perspective taking ability, acquired through task experience, on participants' decision making in reconciling auditor-manager disputes. I find that both ability to take the auditor's perspective and ability to take the manager's perspective increase participants' propensity to support the auditor. The results provide support for appointing an accounting financial expert to the audit committee and suggest the potential benefits of work experience in management positions on audit committee task performance.

Key Words: *Audit committee, Corporate governance, Financial expertise, Perspective taking ability.*

I. INTRODUCTION

The purpose of this paper is to investigate how perspective taking ability, acquired through experience, affects decision making in a disagreement reconciliation task. Prior research on audit committee financial expertise,¹ henceforth “financial expertise,” has examined the impact of audit committee members’ background and experience on audit committee effectiveness. The definition of financial expertise in the originally proposed SEC rule (November 2002) commanded prior accounting-related experience and became the most controversial feature of the proposed SOX rules (SEC 2003). The chief argument against this definition was that the focus on the accounting-specific expertise (experience) was too restrictive and excessively limited the pool of qualified directors. Due to intense criticism, the SEC compromised by adopting a broader definition of financial expertise (March 2003). To examine this issue, recent research categorizes financial expertise into accounting and non-accounting financial experts based on whether they have accounting-related work experience.

Extant literature indicates that accounting financial expertise leads to a lower level of accrual earnings management (Bedard et al., 2004, Carcello et al., 2006, and Dhaliwal and Naiker, 2006), earnings restatement (Abbott et al., 2004) and fraud (Farber, 2005), while enhancing accounting conservatism (Krishnan and Visvanathan, 2005) and internal control quality (Krishnan, 2005). On the other hand, most research fails to find evidence of an association between audit committee effectiveness and non-accounting financial expertise [e.g. Davidson et al. (2004), DeFond et al. (2005), Krishnan and Visvanathan (2005), and Dhaliwal and Naiker (2006)]. These findings suggest the importance of accounting-specific expertise, as described in the SEC’s original proposal, to the audit committee’s role. However, current

¹ Financial expertise is present if at least one member on an audit committee possesses the characteristic.

research is still largely silent on *how* different types of experience affect audit committee member's performance.

Financial experts may be different from non-expert members in at least three ways: domain knowledge content, knowledge schemas, and perspective taking ability. DeZoort and Salterio (2001) indicate that financial experts possess more audit knowledge, compared to other members. McDaniel et al. (2002) emphasize the importance of knowledge by showing that financial experts possess superior schemas for evaluating financial reporting quality relative to financial literates. In addition, because accounting financial experts have first-hand accounting-related work experience, they should have finer ability to take the auditor's perspective than non-accounting financial experts and non-expert members. However, no research thus far examines the merits of perspective taking ability on audit committee effectiveness.

Perspective taking is a process whereby one mentally simulates what others will do or feel in certain circumstances. Prior research in psychology suggests that perspective taking ability has important implications for understanding and resolving social conflict. Because audit committees are responsible for the oversight of the financial reporting process and have to work with auditors and management, perspective taking ability can enhance their performance in certain tasks. A common example is when the audit committee has to reconcile disputes between the external auditor and management, regarding accounting estimates and choices. Managers may have incentives to manipulate financial reports to achieve individual objectives (e.g. reputation and bonus compensation), while auditors are responsible for constraining such opportunistic behavior. To arbitrate auditor-manager disputes, audit committee members receive the information provided by both parties. Accurate perspective taking is expected to improve the

interpretation and use of information from different sources by allowing more precise assessment of source credibility.

In this paper, I report results of an experiment to test whether ability to take the auditor's perspective and ability to take the manager's perspective help participants (acting in the role of audit committee members) make better decisions (i.e. providing more auditor support when appropriate). The ability to take the auditor's perspective should raise audit committee members' awareness of the manager's incentives to be biased, thus increasing their empathy with auditors. In addition, the ability to take the manager's perspective can accentuate the manager's bias and increase the level of auditor support, especially in a weak-deterrent regime that induces managers' biased actions. My experimental results confirm both hypotheses. Further analysis indicates that the effect of the ability to take the manager's perspective on auditor support is contingent upon the degree in which an audit committee member overstates their reports when s/he takes the manager role.

This study contributes to accounting literature and practice by shedding light on the linkage between perspective taking ability, acquired through task experience, and audit committee performance. The results offer another explanation, besides knowledge differences, to prior research's findings that accounting financial experts are superior to non-accounting financial experts. That is accounting financial experts are better in taking the auditor's perspective. The currently adopted definition of a financial expert encompasses non-accounting financial experts such as CEOs and Presidents. These non-accounting experts are presumed to be competent in taking the manager's perspective, but not the auditor's perspective. Hence, the originally proposed definition of financial expertise may be more appropriate because it commands financial experts to acquire this ability through prior work experience in accounting-

related positions. This study also provides evidence supporting the inclusion of directors with management experience on audit committees.

The remainder of the paper proceeds as follows. Section II provides background and develops hypotheses. Section III describes research method and Section IV presents the results. Lastly, I provide concluding remarks in Section V.

II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

Psychological research regards accurate perspective taking as a primary component of social interactions, including business negotiations and group discussions. In particular, simulation theory² indicates that certain regions of a person's brain are used not only to generate behavior but also to predict and infer that of others (Breazeal et al. 2006). Hence, before taking certain actions, people use their prior knowledge and experience to imagine what others will do in the same situation.

Tversky and Kahneman (1974) describe the process of perspective taking as the “anchoring and adjustment heuristic.” People adopt others' perspectives by initially anchoring on their own perspective and then subsequently accounting for differences between themselves and others until a plausible estimate is reached. Prior studies provide evidence supporting the anchoring and adjustment heuristic in perspective taking [e.g. Davis et al. (1996), Van Boven et al. (2000, 2005), and Epley et al. (2004)]. Furthermore, the research shows that egocentric bias arises during perspective taking because people often fail to set aside their own perceptions in estimating others' behavioral actions, even when they know or suspect that others' perception are different from their own. People tend to make insufficient adjustment to their own perspectives

² A theory proposed by Robert Gordon, Alvin Goldman, and other famous philosophers. They suggest that a kind of mental simulation in which one uses himself as a model for another person is an important cognitive mechanism in describing and predicting other people's behavior.

in accommodating differences between themselves and others due to people's assumption that others see or experience the world similarly. The egocentric bias may be even worse under time pressure, which is common in a meeting context (Epley et al. 2004).

An important audit committee task that can benefit from accurate perspective taking is auditor-management dispute reconciliation. Researchers have long recognized the auditor-manager imbalance of power in the audit context; for example, overzealous clients may demand auditors to act in management's economic interests (Knapp 1987). If the auditors refuse to cater to management's interests, auditor-management disputes arise. Audit committees, who serve as liaisons between auditors and management, should intervene in these disputes to reduce management's pressure on auditors. According to SAS No. #90, *Audit Committee Communications*, auditors are required to communicate with audit committees on various issues including disagreements with management. Therefore, informed discussions between the audit committee, the auditor, and the client's management are called for in the presence of an auditor-management dispute. Despite such informed discussions, some audit failures occur because audit committee members do not have adequate sensitivity to the management's immoderate pressure on the auditor (Knapp 1987).

Prior research shows that perspective taking is critical in managing conflicts during discussions because it increases comprehension of other people's messages (Johnson 1967). More accurate perspective taking also helps individuals understand other people's information and perspectives better and retain them longer in their memory (Johnson 1971; Sessa 1996). For example, to decide whether to support the auditor in an auditor-manager dispute, audit committee members may first develop their own perceptions toward the matter after obtaining relevant information from both the auditor and management. They then take into account

differences between their internal states and those of auditors and managers to make adjustment to their own perceptions in their assessment of the auditor's and management's arguments. Finally, they compare auditors' actions to their assessment of what they think auditors should do to determine whether to support auditors. Because both audit committee members and auditors aim for accurate financial reporting, their motivations are aligned and there is no reason to object to auditors' decisions if the audit committee members know with certainty that the auditors did a good job. However, it is possible that despite the auditors doing a good job, audit committee members still disagree with the auditors due to the egocentric bias resulting from the inadequate sensitivity to underlying intention and/or incentives of the auditor and management involved in the dispute.

In a strategic setting involving financial reporting, although the manager has complete information regarding the firm's value, his/her reports may contain bias e.g. overstating earnings to pursue personal economic interests. Because the auditor has incentives to ensure accurate reports, the auditor may have disagreements with the manager. Audit committees are, thus, expected to resolve the disputes. As an audit committee member, not an auditor or a manager, s/he performs perspective taking when trying to interpret information from different sources (the auditor and the manager). Therefore, audit committee effectiveness in arbitrating the disputes should be contingent upon the audit committee members' ability to take the perspectives of the auditor and the manager.

Prior research [e.g. Van Boven et al. (2000)] finds that equipping individuals with relevant experience can help them overcome the egocentric bias when performing tasks involving people in different roles. For instance, buyers often fail to take sellers' perspectives accurately because they ignore the fact that sellers own an object while they do not. This

egocentric bias causes buyers to offer bids that are lower than sellers' threshold. However, letting buyers own an object, without knowing its price, significantly reduces buyer-seller disagreements because the experience of owning an object allows them to adopt the sellers' perspectives more accurately. Therefore, in arbitrating auditor-manager disputes, prior work experience as an auditor or a manager should enhance audit committee members' ability to take the perspectives of the auditor and the manager, respectively. Audit committee members with auditor experience should be able to understand what it feels like to be in the auditor's shoes while manager experience should make them more conscious of the manager's incentives to provide biased reports. In practice, accurate perspective taking may enhance the audit committee member task in several ways. For example, audit committee members who better understand the auditor's and the manager's incentives can better understand and make use of the provided information, develop more strategic thinking, know the right questions to ask, and are more willing to ask for additional information. In this paper, I investigate the effect of more accurate perspective taking, as a result of prior work experience, on audit committee member's assessment of source credibility, which ultimately determines success in auditor-manager dispute reconciliation.

DeZoort et al. (2003) employ source credibility theory to examine the impact of source credibility on the audit committee likelihood to support the auditor and find that source credibility affects the audit committee's decision to support the auditor. According to source credibility theory, source expertise and source bias are important factors that determine the credibility of an information source (Birnbaum and Stegner 1979). Source expertise is defined as the perceived competence of the source in providing information while source bias refers to bias or incentives that are potentially reflected in the source's information. A source is considered as

more credible if it is more competent (higher source expertise) and/or less prone to bias (lower source bias).

Assessing source credibility is important because the recognition of bias will help audit committee members make more accurate adjustment to their own perspectives when trying to adopt those of the auditor and the manager. Considering the auditor's interaction with the manager in financial reporting, the auditor is sensitive to the manager's high source bias. Hence, the ability to take the auditor's perspective should enable audit committee members to recognize the harm of the manager's bias, leading to a discount on the manager's source credibility relative to the auditor. Therefore, audit committee members who can accurately take the auditor's perspective should empathize more with the auditor and, thus, providing more auditor support than those who cannot.

H1: *Audit committee members who are better in taking the auditor's perspective are more likely to support an auditor involved in a dispute with client management.*

Perspective taking theory suggests that the effect of the ability to take the manager's perspective may be twofold. On the one hand, audit committee members with the manager's perspective may focus on the fact that the manager has complete information of the firm's value while the auditor does not. Therefore, they may perceive that the manager's source expertise is higher than that of the auditor. This kind of adherence may make them more likely to support the manager in disputes. On the other hand, the ability to take the manager's perspective should make salient the manager's incentives to be biased. Therefore, they are expected to be more skeptical of the manager's reports and perceive the manager as an information source with low credibility. The ultimate effect of the ability to take the manager's perspective on the likelihood

to support the auditor depends on the degree of both source expertise and potential bias. When the manager has incentives to be biased in the weak deterrence regime e.g. without being constrained by institutional factors such as legal penalties and reputation, the negative effect of source bias on source credibility should dominate the positive effect of source expertise, thus making the manager seems less credible than the auditor (Bowlin et al. 2008). Therefore, in this strategic setting, audit committee members who can accurately take the manager's perspective should side more with the auditor than those who cannot.

H2: *Audit committee members who are better in taking the manager's perspective are more likely to support an auditor involved in a dispute with client management.*

III. RESEARCH METHOD

Overview and Design

I conduct an experiment, which entails two tasks, to investigate the effect of an audit committee member's perspective taking ability on his/her decision making in reconciling auditor-manager disputes. I use simpler (abstract) tasks in the experiment to control for possible prior knowledge differences among subjects.³ The experiment includes three groups: (1) the auditor group, (2) the manager group, and (3) the control group. Participants in the first two groups complete both the first (auditor-manager) and second (audit committee) tasks, whereas participants in the control group only complete the latter task. The experimental design allows me to disentangle the effect of perspective taking ability from that of knowledge as well as to examine the effects of the auditor's perspective and the manager's perspective, separately.

³ An abstract setting is used in the experiment to avoid the potential effects of participants' prior knowledge and experience. However, I use contextually rich terminology in this paper for expositional convenience.

Participants

A total of 82 undergraduates of a medium-sized university in the U.S. participated in the experiment. The participants were randomly assigned to one of the three groups, with approximately the same number per group. Undergraduates are suitable for this experiment because I want to control for participants' prior knowledge or work experience as much as possible.

In the first (auditor-manager) task, each participant in the auditor group is assigned the role of auditor while each participant in the manager group is assigned the role of manager.⁴ At the beginning of each round, auditor-manager pairings are randomly determined. Participants are never informed of the identity of their paired partner. The role assigned to each participant does not change throughout the experiment. This task is designed to provide participants with the ability to perform perspective taking. The second (audit committee task) is an individual task in which each participant is assigned a role of audit committee member.⁵ Participants in the auditor group and the manager group perform this task after the first task is completed. In contrast, participants in the control group only perform the audit committee task.

Experiment Procedures

Instructions are distributed and read aloud by an experimenter. Participants are given ample time to read them and ask questions before the experiment begins.

First Task (Auditor-Manager)

⁴ The experimental materials refer to the auditor as the "Receiver" and the manager as the "Sender" to prevent the potential effects of descriptive labels.

⁵ The experimental materials call the audit committee member the "Predictor" (per Footnote 4).

The main objective of the auditor-manager task is for participants in the auditor group and the manager group to gather relevant experience before participating in next task. The auditor-manager task simulates the auditor-manager relationship in a financial reporting context to provide participants with the ability to perform perspective taking. In financial reporting, managers generally have complete information about their own company and report the company's earnings with some level of discretion. Managers may have incentives to provide biased reports (e.g. to preserve job security, boost performance-based compensation, or increase reputation). Prior literature documents manager's propensity to avoid negative earnings surprises and to reach certain earnings targets by managing earnings [e.g. Brown (2001) and Bartov et al. (2002)]. By comparison, auditors are expected to constrain managers' opportunistic behavior. Also, auditors may face an asymmetric loss function, making them more concerned with income-increasing earnings management than income-decreasing earnings management (i.e. being more conservative). If the manager's reported value is deemed to be materially misstated, an auditor-manager dispute arises and an audit committee meeting may be scheduled. Both parties are expected to exert effort and invest time in the meeting and the company incurs additional cost to arrange the meeting.

The auditor-manager task can be described as a dynamic game of incomplete information as depicted in Figure 1.⁶ The payoff functions are common knowledge to both players. At the beginning of each round, the actual commodity value is determined by drawing two integers (signals) with replacement from a uniform distribution $U(0, 50)$. The commodity value is the sum of the two signals, thus ranging from 0 to 100, with an expected value of 50. One of the two

⁶ The game consists of multiple rounds and players are informed of their payoffs privately at the end of each round. Players may update their beliefs by incorporating new information so the equilibrium strategies depend on each player's beliefs as well as their learning mechanism. I do not introduce specific beliefs and solve for the Perfect Bayesian Equilibrium since no prediction about players' action is made.

signals is then selected at random and given to all auditors and managers so the signal becomes public knowledge. However, only the managers are informed of the commodity's actual value (the sum of the two signals). The managers also know which integer is public knowledge and which one is their private knowledge.

The manager is the first mover and the auditor is the second mover in this task. After the signals and commodity's value are determined, each manager submits a reported value of the commodity to the paired auditor. The auditor then (1) comes up with his or her own estimate of the commodity's value, and (2) chooses either the auditor's own estimate or the manager's reported value as the final estimate of commodity value. Figure 2 illustrates detailed steps in the first task.

The auditor's payoff increases with the accuracy of his or her estimate of the real value of the commodity. The auditor receives a reward of 50 points if the estimate error (the final estimate – the commodity's actual value) falls within the range of -15 to 10 Liras⁷ and 10 points otherwise.⁸ Moreover, 10 points are deducted from the auditor's payoff if s/he rejects the manager's reported value and uses own estimate of the commodity's value as the final estimate.⁹ In addition, the auditor earns a bonus based on the accuracy of his or her own estimate, regardless of whether s/he uses the manager's reported value or own estimate. The bonus is calculated as $(100 - |\text{his or her own estimate} - \text{the actual commodity value}|)/10$. Therefore, the auditor can earn up to 10 bonus points in this task.

⁷ Lira is a hypothetical currency used for the commodity valuation in the experiment.

⁸ The acceptable range is asymmetric around zero because auditors generally prefer conservative accounting choice due to litigation risk concerns (e.g. DeFond and Subramanyam 1998). So they are more likely to focus on income-increasing than income-decreasing earnings management.

⁹ The cost of 10 Liras is imposed because auditors typically have to exert more efforts (e.g. gathering more evidence) to further explore suspicious reporting issues.

The manager's payoff increases as the manager's reported value increases as long as the reported value is accepted by the auditor. The payoff equals 1 point times the reported value. However, if the reported value is rejected by the auditor, then his/her point reward becomes 60% of the actual commodity value. Figure 3 depicts the payoffs to both players.

Once both players finish their actions, payoffs are calculated and each player is privately informed of his/her payoff for the round. Participants are re-paired and the new round begins. This task is repeated for four rounds. After the fourth round is done, the cash payoffs are determined. Participants are paid based on their performance in a randomly selected period using a conversion rate of 5 points per dollar.

Second Task (Audit Committee)

After the first task is completed, everyone (all three experimental groups) participates in the audit committee task, which involves auditor-manager dispute reconciliation. All participants assume the role of audit committee member, whose task is to predict the commodity value. The experimenter explains the roles and payoff functions of the auditor and the manager from the first task to all participants. At the beginning of each round, audit committee members receive information from a randomly selected disagreement from the auditor-manager task.¹⁰ The audit committee members are informed of (1) the signal given to the auditor, (2) the manager's reported value, and (3) the auditor's own estimate of the commodity's value. Then, they are asked to (1) predict which of the manager's reported value and the auditor's own estimate is closer to the actual commodity value, and (2) predict the actual commodity value.

¹⁰ For convenience, the disagreements used in the task will be pre-selected from a prior session of the experiment. Also, to prevent experimental noise, all participants receive the same set of information in each round of the task.

The audit committee member's payoff increases with the accuracy of his or her estimate (E) compared to the actual commodity value (A).¹¹ Specifically, each player receives a reward of 50 points minus 1 point for each Lira in absolute error ($50 - |E - A|$). In addition, s/he receives an additional 20 points if his prediction regarding which of the manager's reported value and the auditor's own estimate is closer to the actual commodity value is correct. The task is repeated five rounds. No feedback is given until the conclusion of the second task.¹² Upon completion, the experimenter, with the help of an assistant, calculates each participant's monetary payoff, asks them to complete the post-experiment survey, and pays them in cash. As in the first task, participants will be paid based on their performance in a randomly selected round using a conversion rate of 5 points per dollar.

IV. RESULTS

The results of the first (auditor-manager) task are summarized in Table 1. As shown in Panel A, Managers tend to overstate the commodity value. On average, the manager's reported value is 9.75 above the actual commodity value and 10.05 above the middle of possible range (the publicly known integer + 25). Auditors tend to discount the manager's reported value, as reported in Panel B. On average, the auditor's estimate is 5.38 less than the manager's reported value. However, the auditor's adjustment does not totally remove the manager's bias since the average auditor's estimate is 4.37 above the actual value and 4.67 above the middle of possible range. About two-thirds of the manager's reports are accepted by the auditor. However, Figure 4 depicts that the auditor's acceptance rate generally decreases with the manager's reported value.

¹¹ Bedard et al. (2004) indicate that unlike auditors, audit committee members do not have an asymmetric loss function and are concerned with both income-increasing as well as income-decreasing earnings management.

¹² No feedback is provided in this task because experience as an audit committee is not the focus of this paper. Therefore, this treatment allows for cleaner data.

All in all, the first task is successful in allowing participants to gain experience in the commodity valuation task in which specific incentives are used to simulate an auditor-manager interaction.

Insert Table 1 Here

Next, I test the hypotheses using participants' decisions in the second (audit committee) task of the experiment. In the auditor-manager task, the differences between the manager's reported value and estimate when the auditor rejects the manager's report range from -11 to 46, with the mean of 10.76. In the selected cases used in the audit committee member task, managers' reported values exceed auditors' estimate by 8.40 on average, ranging from 7 to 10. Therefore, the selected cases of auditor-manager disputes used in the second task are good representatives of auditor-manager disputes with medium magnitude.

Auditor Support

I construct the experiment in a way that all participants have knowledge of the incentives of both the auditor and the manager, so they can form ideas toward individuals in each role. However, participants in each of the three groups have different types of experience, obtained from the first task, so their perspective taking ability varies. I expect participants assigned to the auditor group to have high ability to take the auditor's perspective and participants assigned to the manager group to have high ability to take the manager's perspective. Participants in the control group have low ability to take both perspectives because they do not complete the first task.

The first and the second hypotheses (H1 and H2) focus on the ability to take the auditor's perspective and the ability to take the manager's perspective, respectively. I use two variables, SUPPORT and MIDDIFF, to capture this propensity. The dichotomous variable SUPPORT equals 1 if the participant agrees that the actual commodity value is closer to the auditor's estimate than the manager's reported value, or 0 otherwise. Panel A of Table 2 shows the frequencies of participants' first predictions by group. Obviously, participants in the control group provide less support to the auditor (33.57%) than those in the other groups (51.11% for the auditor group and 52.59% for the manager group). Participants in the auditor and the manager groups are relatively similar in their likelihood to support the auditor. The chi-square test of independence is statistically significant (p -value = 0.002) so whether a participant supports the auditor depends on which group he or she was assigned into.

Insert Table 2 Here

The second variable of interest is MIDDIFF, which is the difference between the participant's estimate and the middle point between the manager's reported value and the auditor's estimate. This variable adds on SUPPORT because it gauges the strength, in addition to the existence, of participants' auditor support. Panel B of Table 2 displays that the mean and median of MIDDIFF are close to zero so participants' estimates, on average, are around half way between the manager's reported value and the auditor's estimate. The more negative the MIDDIFF, the more support the participant provides to the auditor. In contrast, the more positive the MIDDIFF, the more support the participant provides to the manager, and less to the auditor. According to Table 2, the average estimate of participants in the control group is closer to the

manager's reported value, while the average estimates of those in the auditor and manager groups are closer to the auditor's estimate.

The above results manifest the potential importance of perspective taking ability in audit committee members' decision making. Therefore, I run two regression models to investigate the effects of the ability to take the auditor's perspective and the ability to take the manager's perspective. The first regression (Panel A) is a logit model that regresses SUPPORT on two dummy variables, *Auditor* and *Manager*. *Auditor* equals 1 if the participant was in the auditor group or 0 otherwise, while *Manager* equals 1 if the participant was in the manager group or 0 otherwise. The second regression (Panel B) is a linear model that regresses MIDDIFF on *Auditor* and *Manager*. The first regression examines the relationship between participants' perspective taking ability and their valence of auditor support and the second regression investigates the relationship between the perspective taking ability and their magnitude of auditor support.

Insert Table 3 Here

The first hypothesis (H1) predicts that participants in the auditor group will provide more auditor support, compared to those in the control group. As a result, I expect the coefficient of *Auditor* to be positive for the first regression (SUPPORT) but negative for the second regression (MIDDIFF). According to Panel A of Table 3, the auditor's perspective significantly increases the participant's likelihood to side with the auditor (one-sided p-value = 0.009). In addition, Panel B of Table 3 shows that on average, the estimates of participants with the auditor's perspective are closer to the auditor's estimate than the control group, and this effect is marginally significant (one-sided p-value = 0.095). It is also notable that the constant term for

the second regression is not statistically different from zero ($p\text{-value} = 0.264$). This implies that participants tend to use the middle point between the manager's reported value and the auditor's estimate as their benchmark in estimation. Overall, the results provide nice support to H1 because the ability to take the auditor's perspective makes participants more likely to side with the auditor and sway their estimates to the auditor's side. Therefore, I conclude that the ability to take the auditor's perspective positively affects participants' valence and magnitude of auditor support.

Next, I test the second hypothesis (H2) by examining the coefficient of *Manager* in the two regressions. H2 projects that the level of auditor support of participants in the manager group is more than that of the control group. According to Panel A of Table 3, the ability to take the manager's perspective significantly increases participants' propensity to side with the auditor (one-sided $p\text{-value} = 0.003$). Furthermore, as shown in Panel B, the estimates of participants with the manager's perspective are significantly closer to the auditor's estimate than the manager's reported value (one-sided $p\text{-value} = 0.006$). Therefore, I conclude that, like the ability to take the auditor's perspective, the ability to take the manager's perspective positively affects the participants' valence and magnitude in providing auditor support. This implies that the impact from taking the manager's perspective and recognizing the incentives to be biased outweighs the possible drawback from adherence to the fact that the manager has more (complete) information without making sufficient adjustment to the manager's report.

Reasons for Auditor Support

Based on previous analyses, both the ability to take the auditor's perspective and the ability to take the manager's perspective increases audit committee members' propensity to

support the auditor. However, it is tenable that the auditor group and the manager group support the auditor for different reasons. Specifically, I conjecture that, compared to the control group, participants in the auditor group are more likely to support the auditor because they can take the auditor's perspective more accurately. The more precise auditor perspective makes them more susceptible to the manager's incentives to be biased, thus reducing their perception of the manager's source credibility.

On the contrary, the manager group is likely to support the auditor due to their sensitization to the manager's incentives, which magnifies the manager's source bias. However, the manager's source credibility is determined by source expertise as well as source bias. It is possible that during perspective taking, participants in the manager group fixate on the fact that the manager knows the actual commodity value so they may perceive that the manager has greater source expertise than the auditor. Therefore, participants in the manager group should support the auditor only when their skepticism to the manager's incentives, which decreases the manager's source credibility by heightening source bias, is high enough to outweigh the effect of source expertise on source credibility. In my experiment, participants in the manager group who are more biased in the first task should have higher degree of skepticism toward the manager's report in the second task. As a result, the higher the amount of inflation they put in their reports in the first task, the greater the expected auditor support they provide in the second task. I conduct additional analyses to examine this possibility. Table 4 presents the results.

Insert Table 4 Here

First, Panel A presents the breakdown of positive and negative estimation errors by experimental group. The control group appears more likely to overestimate commodity value than the other two groups. However, the chi-square test of independence suggests that there is no difference in signs of estimation errors among groups (p-value = 0.166). Therefore, perspective taking ability does not significantly affect the likelihood that a participant makes positive or negative estimation errors. This provides additional support to the previous results that both the auditors and the manager groups provide more support to auditors in auditor-manager disputes without excessively underestimating the commodity value.

Next, I examine the relationships between participants' performance in the first and second tasks. In particular, for the manager group, I test the association between the degree that the participants inflate value in the first task and the degree that the participants discount the manager's report in the second task. I expect that the more the participant inflates commodity value in the first task, the more he or she discounts the manager's report in the second task. Panel B displays the results from the correlation analysis. The positive and statistically significant correlation (p-value = 0.009) between inflation in the first task and discount in the second task lends support to my conjecture. In addition, for the auditor group, I test the association between the degree that the participants discount the manager's reported value in the first and second tasks. However, I fail to find a significant correlation (p-value = 0.136). Hence, unlike the manager group, the magnitude of auditor support of the auditor group is not related with the participants' decisions in the auditor-manager task.

V. CONCLUSION

I use a laboratory experiment to investigate the effect of the ability to take the auditor's perspective and the ability to take the manager's perspective on audit committee members' task performance in reconciling auditor-manager disputes. When there is a dispute between the auditor and the manager, I find that both kinds of perspectives can improve audit committee members' propensity to support the auditor. In addition, the effect of the manager's perspective increases with the degree to which an audit committee member inflates the reported value when he or she takes the role of manager in the auditor-manager task. I conclude that the ability to take the auditor's perspective allows audit committee members to better empathize with the auditor while the ability to take the manager's perspective allows them to be better sensitized to the manager's incentives. These mechanisms make salient the manager's source bias, thus lessening source credibility of the manager relative to the auditor. The results of my experiment provide an additional explanation to the findings that financial experts qualified by different definitions (e.g. accounting vs. non-accounting) may diversely affect the firm's financial reporting. That is, they are different in their competence in taking perspectives of auditors and client management.

The comparison between the effects of the auditor's perspective and the manager's perspective can have important implications to the definition of financial expertise but there are some caveats to the results. Although the experimental design allows me to measure the effects of the ability to take the auditor's perspective and the ability to take the manager's perspective separately,¹³ the comparison must be done with caution since it can be very sensitive to protocols used in the experiment. In this experiment, participants are provided limited information and there is a considerable randomness that determines their task performance. I suspect that the

¹³ This has not been done in prior literature due to the fact that "accounting financial experts" can have work experience in both accounting and management positions. So it is very difficult to disentangle the effects of the auditor's perspective and the manager's perspective using archival data.

differences in task performance among groups could be more salient in a setting involving more information and less uncertainty.

It is improper to conclude from the analyses that the manager's perspective can be a substitute for the auditor's perspective. Although the effects of both perspectives seem comparable, the auditor's perspective may have a significant incremental value beyond that offered by the manager's perspective. One possible way to investigate this question is to compare task performance of individuals who can take only the manager's perspective and the performance of those who can take both the auditor's and the manager's perspective. This would directly address the issue regarding the definition of financial expertise - whether first-hand accounting experience should be a requirement. If the auditor's perspective has an incremental value to the audit committee member's task performance, appointing an accounting financial expert can be more beneficial to the firm's financial reporting than a non-accounting financial expert, even if their knowledge is equivalent. In addition, the impact of the manager's perspective on auditor support could be less pronounced in a strong-deterrent regime that put more constraints on managers' opportunistic actions than my experimental setting. I leave these issues for future studies.

This paper contributes to accounting literature and practice in several ways. First, the ability to take the auditor's perspective is beneficial in resolving auditor-manager conflicts, which is a common audit committee members' task. Therefore, appointing accounting financial experts may be justified because audit committee effectiveness can be enhanced by more accurate perspective taking as well as superior accounting knowledge. The ability to take the manager's perspective can also improve audit committees' task performance. This provides a possible explanation to Knapp's finding (1987) that audit committee members who were active

managers of publicly traded companies are more likely to support auditors in auditor-manager disputes.

The question of whether the ability to take the auditor's perspective can be completely substituted by the ability to take the manager's perspective remains open. Future research can investigate this issue by examining the incremental effect of the ability to take the auditor's perspective, in addition to the manager's perspective. Moreover, the significant effects of the ability to take the manager's perspective imply that it may not always be appropriate to dichotomize financial experts into accounting and non-accounting experts when conducting related research. Some accounting experts may have work experience in management positions as well as accounting experience so they should be able to understand both perspectives well. Furthermore, we can extend this stream of research by studying the interactional effect of knowledge difference and perspective taking ability. Because financial experts are deemed to possess different knowledge from non-experts, future research can study the impact of knowledge difference and perspective taking ability on audit committee members' task performance simultaneously. This research could shed insight on whether different types of knowledge and perspective taking ability can be complements or substitutes of one another.

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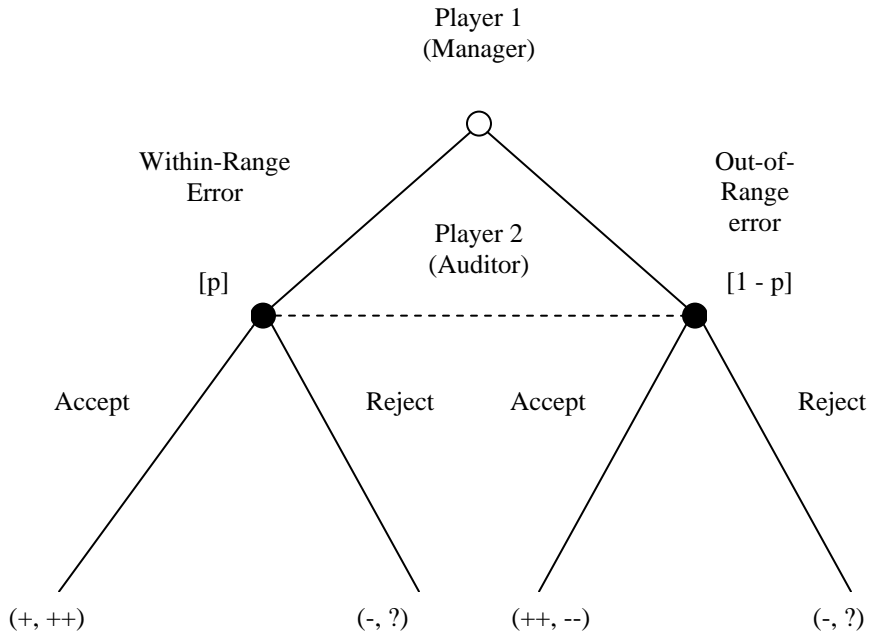
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Figure 1- Extensive Game Form of the Auditor-Manager Task



Where p is the probability of the reported value containing an acceptable error; the signs $(+, +, -, --)$ in parentheses indicates magnitude of payoff for the manager and the auditor, respectively, where $++ > + > - > --$; the question mark (?) indicates an uncertain payoff, depending on the auditor's ability to estimate the commodity value.

Figure 2 – Procedure in the Auditor-Manager Task

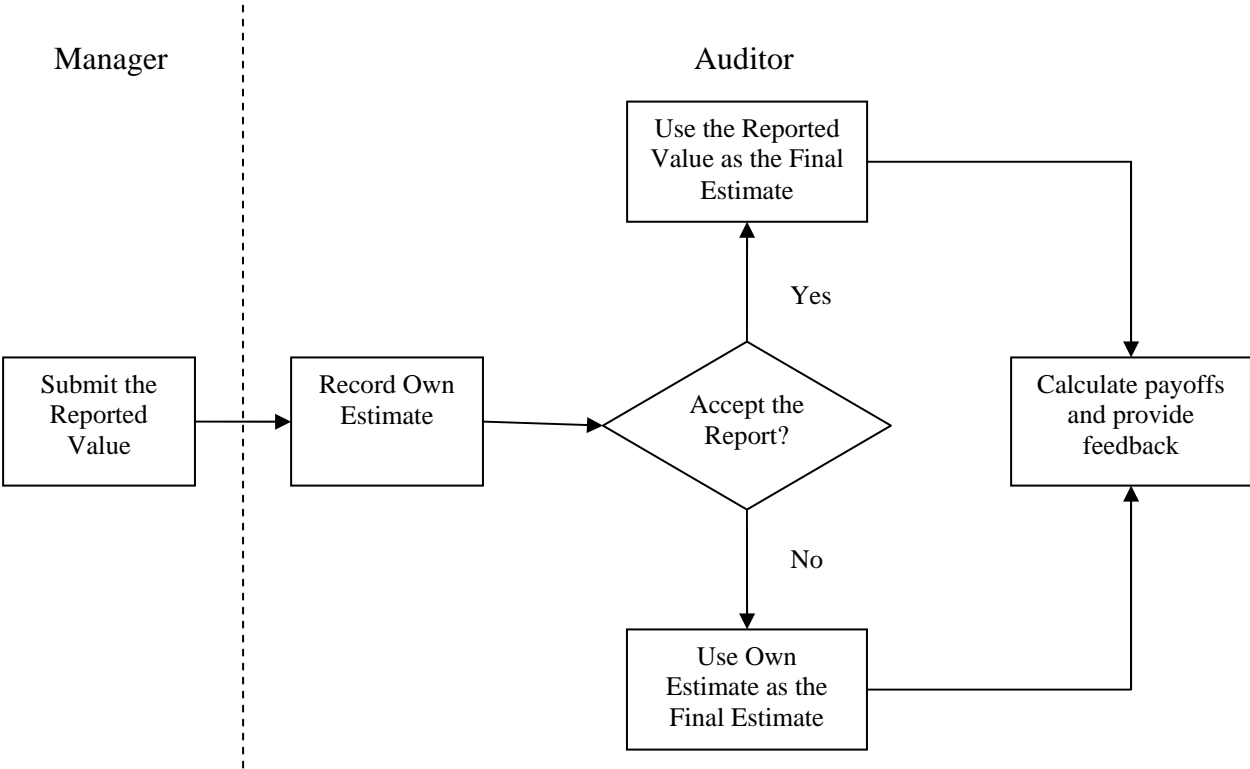
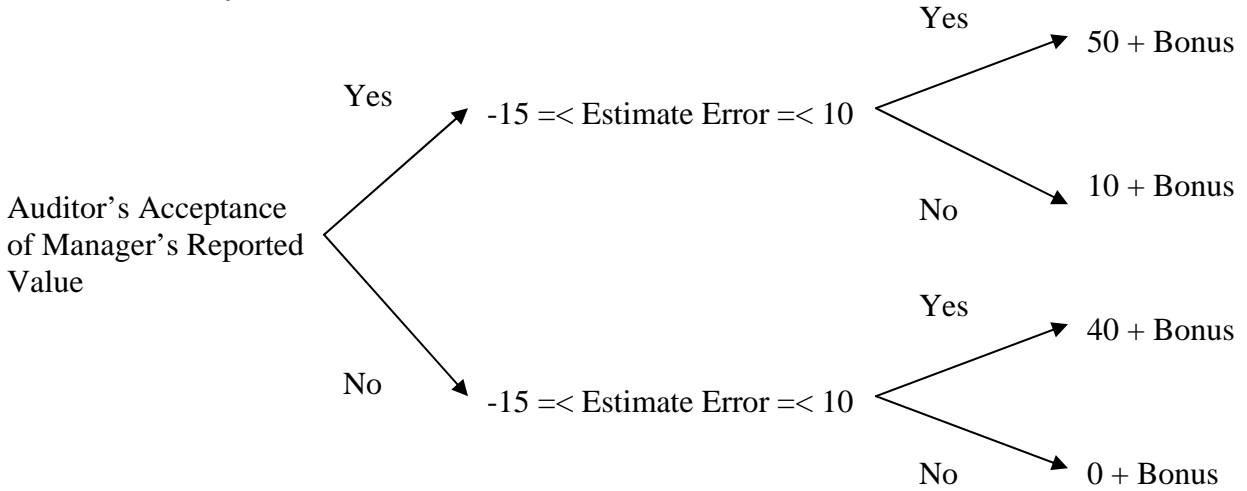


Figure 3 – Payoffs in the Auditor-Manager Task

The Auditor’s Payoff (Points)



Where $\text{Bonus} = (100 - |\text{his own estimate} - \text{the commodity's actual value}|)/10$.

The Manager's Payoff (Points)

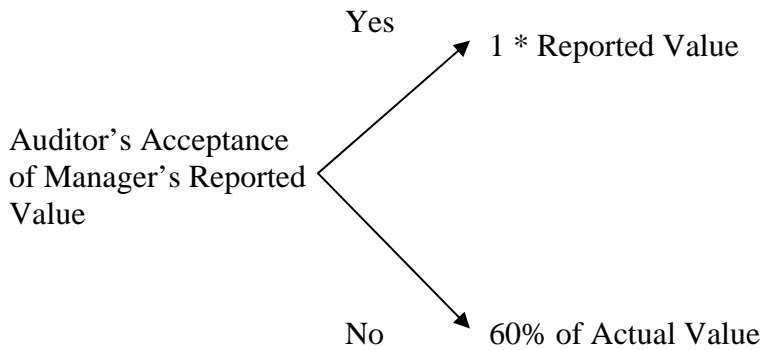


Figure 4 – The Frequency Distribution of the Auditor’s Acceptance of the Manager’s Reported Values

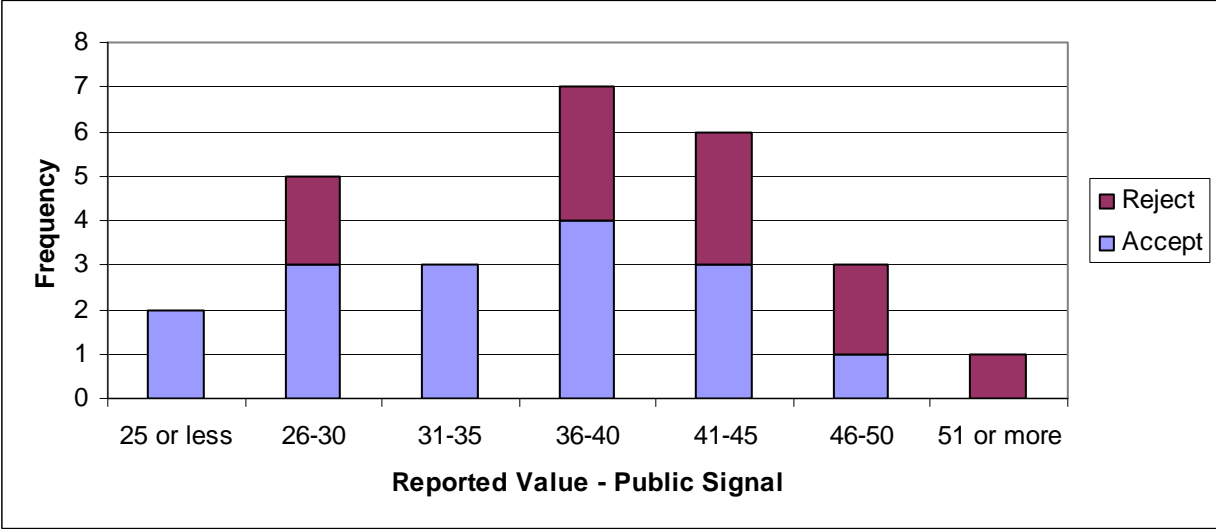


Table 1
Summary of Task I Results

Panel A: Manager's Report

<u>Variable</u>	<u>Mean</u>	<u>Median</u>	<u>Standard Deviation</u>
Reported Value	56.59	54	15.953
Reported Value (after Taking out the Public Signal)	35.05	34	12.752
Reported Value – Actual Value	9.75 ***	9	12.242
Reported Value – Middle of Possible Range ^a	10.05 ***	9	12.752

Panel B: Auditor's Estimation

<u>Variable</u>	<u>Mean</u>	<u>Median</u>	<u>Standard Deviation</u>
Estimate	51.21	50.5	12.815
Estimate (after Taking out the Public Signal)	29.67	29	9.856
Estimate – Actual Value	4.37 ***	5.5	13.163
Estimate – Middle of Possible Range	4.67 ***	4	9.856

Panel C: Auditor's Propensity to Accept Manager's Report

<u>Situation</u>	<u>Percentage</u>
Overall	66.96%
When Manager's Reported Value > Actual Value	65.85%
When Manager's Reported Value > Middle of Possible Range	62.07%

^a Middle of Possible Range equals to the publicly known integer plus 25.

*** The mean is statistically different from zero at the 1% significance level.

Table 2
Descriptive Statistics of the First Prediction (Task II)

Panel A: Participants' responses (SUPPORT)

<u>Group</u>	<u>Auditor</u>	<u>Manager</u>	<u>Total</u>
Control	47	93	140
Auditor	69	64	135
Manager	71	66	135
Total	187	223	410
Pearson Chi ²	12.479		
Prob > Chi ²	0.002	***	

Panel B: Summary statistics of SUPPORT and MIDDIFF^a

<u>Group</u>	<u>SUPPORT</u>	<u>MIDDIFF</u>		
	<u>Percentage</u>	<u>Mean</u>	<u>Median</u>	<u>Standard Deviation</u>
Control	33.57%	0.786	0.500	6.649
Auditor	51.11%	-0.407	0.500	4.871
Manager	52.59%	-1.341	-0.500	4.206
Total	45.61%	-0.307	0.500	5.418

^a Variable definitions:

SUPPORT equals 1 if the predictor agrees that the actual commodity value is closer to the auditor's estimate than the manager's reported value, or 0 otherwise.

MIDDIFF is the difference between the predictor's estimate and the middle point between the manager's reported value and the auditor's estimate.

Table 3
Regression Models for the Auditor Support (Task II)

Panel A: Logistic Model of SUPPORT Regressed on Auditor and Manager's Perspectives^a

$$SUPPORT = \beta_0 + \beta_1 Auditor + \beta_2 Manager$$

<u>Independent Variable</u>	<u>Predicted Sign</u>	<u>Coefficient</u>	<u>Standard Errors^b</u>	<u>Probability^c</u>
Intercept		-0.682	0.219	0.002 ***
Auditor	+ (H1)	0.727	0.308	0.018 ***
Manager	+ (H2)	0.786	0.287	0.006 ***
Prob > Chi ²		0.014 **		
Pseudo R ²		0.022		

Panel B: Linear Models of MIDDIFF Regressed on Auditor and Manager's Perspectives^a

$$MIDDIFF = \beta_0 + \beta_1 Auditor + \beta_2 Manager$$

<u>Independent Variable</u>	<u>Predicted Sign</u>	<u>Coefficient</u>	<u>Standard Errors^b</u>	<u>Probability^c</u>
Intercept		0.786	0.698	0.264
Auditor	- (H1)	-1.193	0.900	0.189 *
Manager	- (H2)	-2.126	0.818	0.011 ***
Prob > F		0.034 **		
R ²		0.026		

^a Variable definitions:

SUPPORT equals 1 if the predictor agrees that the actual commodity value is closer to the auditor's estimate than the manager's reported value, or 0 otherwise.

MIDDIFF is the difference between the predictor's estimate and the middle point between the manager's reported value and the auditor's estimate.

Auditor equals 1 if the predictor was designated as an auditor in Task I, or 0 otherwise.

Manager equals 1 if the predictor was designated as a manager in Task I, or 0 otherwise.

^b Clustered robust standard error is used to control for within-subject error (clustered variable = subject ID).

^c Two-sided probability.

Table 4
Relationships between decisions in Task I and Task II

Panel A: Breakdown of Positive and Negative Estimation Errors

<u>Group</u>	<u>Understatement or No Error</u>	<u>Overstatement</u>	<u>Total</u>
Control	7	21	28
Auditor	12	15	27
Manager	13	14	27
Total	32	50	82
Pearson Chi ²	3.592		
Prob > Chi ²	0.166		

Panel B: Correlations between decisions in Task I and Task II

		<u>Discount in Task II</u>	
Manager's inflation in Task I	Pearson Correlation	0.496	
	Probability (2-tailed)	0.009	***
Auditor's discount in Task I	Pearson Correlation	0.294	
	Probability (2-tailed)	0.136	