

**Users' Judgments of Managers and Auditors:
The Impact of Accounting Treatment and Reconciliation**

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ABSTRACT

We examine how accounting disclosures affect users' assessments of management credibility and, in turn, their expectations of the auditor. In a lease obligation setting, our experiment separates the effects of understanding the financial impact of accounting treatment (by manipulating the presence of a supplemental reconciliation from disclosure to recognition) from inferences made based on management's choice of accounting disclosures (by manipulating the source of the reconciliation). Users who receive a reconciliation report lower management credibility, higher investment risk, and higher audit expectations when the reconciliation is provided by a source other than management. By documenting boundary conditions in which audit expectations are *higher* for disclosed information, we extend research on the influence of reporting discretion to audit expectations, with implications for the expectation gap and auditors' potential business risk.

Keywords: *management credibility, perceived audit quality, expectation gap, recognition, disclosure, disaggregation, reconciliation*

Data availability: *contact the authors*

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I. INTRODUCTION

The recent renewal of public concern over auditors' potential conflicts of interest and pressures to favor management (e.g., Moore et al. 2006; Nelson 2006) has coincided with increasing concerns about financial disclosure credibility (Mercer 2004) and the importance of 'closing' the audit expectations gap (Zhang 2007). In this paper, we examine how accounting disclosures affect financial statement users' assessments of *management credibility* and their *audit expectations*. Management credibility represents financial statement users' beliefs about management's overall level of trustworthiness and competence (Mercer 2004). However, management trustworthiness and competence are also key components of a company's control environment, or 'tone at the top,' which are considered critical to audit planning (COSO 1994; AICPA 2006). With research in psychology suggesting that individuals expect their beliefs and concerns to be shared by others (e.g., Keysar et al. 1995), we examine circumstances under which financial statement users are more likely to expect the company's auditors to have shared their beliefs about management credibility and to have accordingly adjusted their skepticism and effort in planning and performing the audit.

Recent research has found that investors' perceptions of financial disclosure credibility vary more when the disclosure is voluntary (i.e., not mandated by generally accepted accounting principles, GAAP) or even when in accordance with GAAP if investors believe that substantial discretion remains in accounting treatments (Hodge et al. 2006). Standards reinforcing auditors' responsibility to consider the overall quality of a company's accounting principles *beyond* compliance are also relatively recent (e.g., SAS No. 90). There are currently no objective criteria for the consistent evaluation of quality (AICPA 1999; Munter 2001), with little professional

guidance on how audit strategies should be adjusted for corporate governance factors (Cohen et al. 2002). Thus, financial statement users and auditors may reasonably differ in the credibility assessments they make based on such disclosures.

The lease obligation setting examined by Libby et al. (2006) and Nelson and Tayler (2007) provides an example of the potential contrast between financial statement users' and auditors' judgments. Specifically, Libby et al. find that audit partners are willing to tolerate more misstatement in disclosed rather than recognized financial statement items. The differences in tolerable misstatement occur at least in part because auditors view misstatements in disclosed amounts to be less material. This viewpoint may arise because of lower perceived litigation risk, with auditors expecting users to place lower weight on disclosed information.¹

However, Nelson and Tayler (2007) find that relatively sophisticated financial statement users weight lease information *more heavily* when users adjust (or *reconcile*) the financials to appear as if the initially disclosed leases had instead been recognized. Nelson and Tayler also provide preliminary evidence that users who are presented with that reconciliation perceive management as less credible than users presented only with recognition. This finding is consistent with reconciliation highlighting the financial impact of the accounting treatments for users, who may then perceive management as less forthcoming despite conforming with GAAP. Nevertheless, open questions remain about the circumstances under which users will weight disclosed information more heavily, will do so because of inferred differences in management credibility, and, in turn, will alter their audit expectations.

¹ Libby et al. (2006) document auditors' willingness to tolerate greater misstatement in both balance sheet and income statement items (lease obligations and stock option compensation, respectively). The expectation that users place lower weight on disclosed information is consistent with prior evidence on the recognition versus disclosure of leases (Imhoff et al. 1993; Munter and Ratcliffe 1983; Wilkins and Zimmer 1983b), post retirement benefits (Davis-Friday et al. 2004; Harper et al. 1987), real estate asset revaluations (Cotter and Zimmer 2003), stock option compensation (Belzile et al. 2006; Frederickson et al. 2006), research and development (Entwistle 1999), and fair value income (Hirst et al. 2004).

Key features of the lease obligation setting make it particularly well-suited for our experimental investigation of users' assessments of management credibility and related audit expectations. First, this setting allows management the reporting flexibility that has previously been shown to impact investors' perceptions of financial disclosure credibility (e.g., Hodge et al. 2006). Managers are more likely to attempt earnings management by structuring transactions around precise standards (such as the specific thresholds stated in SFAS No. 13 with respect to leases), and auditors are less likely to adjust such attempts (Nelson et al. 2002). Thus, although current GAAP would appear to be restrictive, managers retain some flexibility to choose between accounting treatments (albeit at a cost of structuring the transaction). Second, despite that flexibility, there is a clear divide between management's and sophisticated users' preferences for lease accounting. Managers generally have incentives to prefer off-balance sheet disclosure of lease obligations. In contrast, sophisticated users generally prefer recognition for all lease obligations (e.g., SEC 2005; S&P 2006). The difficulty of the constructive capitalization adjustment implies, however, that only relatively knowledgeable users are likely to attempt the reconciliation from disclosure to recognition (as in Nelson and Tayler 2007).

In our experiment, we leverage these features to separate the effects of users' understanding of the financial impact of the accounting treatment (by manipulating the presence of a supplemental reconciliation) from their inferences based on management's choice of accounting treatment and disclosures (by manipulating the stated source of the reconciliation). By doing so, we offer insights into circumstances under which users make inferences about management credibility and extend those inferences to their investment and audit expectations.

We vary the financial disclosures for a company's lease obligations in a 1×4 between-subjects design. In the first two (control) conditions, the lease obligations are either disclosed or recognized. In the remaining two (treatment) conditions, participants receive a supplemental

reconciliation indicating the company's financial results as if the disclosed lease obligations had instead been recognized. The source of the reconciliation is manipulated as either company management or an independent research analyst. We examine the consequences of participants' understanding of the financial impact of the lease obligations by comparing responses between the two control conditions. This comparison captures the effects of imposing the accounting treatment preferred by relatively sophisticated users but without increasing its salience. Such salience likely would occur naturally for more sophisticated users (as in Nelson and Tayler 2007) through their existing knowledge. We evaluate the inferences participants make based on management's reporting flexibility and corresponding choice of accounting treatment and disclosures by comparing responses with the two treatment conditions. These two conditions ensure that participants are aware of the financial impact of the disclosed lease obligations (via explicit reconciliation) and hold constant the salience of the financial impact of management's within-GAAP accounting choices (via equal emphasis for both sources).

Participants evaluate three dependent measures: management credibility, investment risk, and audit expectations. Results from the control conditions confirm that disclosed information alone tends to affect investment risk judgments *less than* recognized information, supporting a key assumption for audit litigation risk to be lower with disclosed amounts (Libby et al. 2006). Users are unlikely to differ in their views of management credibility or in their audit expectations unless prompted to do so (in our experiment, via reconciliation), again consistent with generally lower audit litigation risk. Results from the treatment conditions indicate that users who receive a reconciliation from an outside source report lower management credibility, higher investment risk, and higher audit expectations relative to control conditions as well as relative to users who receive a management-sourced reconciliation. These findings suggest conditions in which audit

expectations are *higher* (and, thus, auditors' litigation risk may also be higher) for disclosed information than for recognized information.

Our research extends several lines of current literature. First, we extend research on recognition versus disclosure by demonstrating the effects of the presence and source of reconciliation on investment risk and management credibility judgments. Our results indicate the differential impact of legitimate, within-GAAP accounting choices on users' judgments when those choices are salient. The effects could, at least in short term evaluations, offset the potential benefits of managing earnings or debt information.

Second, we extend research on the influence of managerial reporting discretion on expectations of auditors' planning and performance. Our results provide evidence that an auditor's business risk can change with users' *ex post* assessments of management credibility, in keeping with recent standards reinforcing auditors' obligations to consider the overall quality of a company's accounting principles beyond rules-based GAAP compliance (e.g., SAS No. 90).

Finally, we extend research on the expectation gap and auditors' potential litigation risk as it relates to the standard of care for recognized versus disclosed amounts. Because disclosed amounts are expected to be given less attention than recognized amounts, auditors may act as if the risks associated with them are lower (Libby et al. 2006). Our results suggest boundary conditions—through the effect of reconciliation on management credibility judgments, users' expectations of auditor diligence (and thus auditors' exposure to risk) may be *higher* for disclosed versus recognized amounts, even if management's choices conform to GAAP. The extant research suggests that auditors are sensitive to client risk factors, but finds mixed results with respect to whether audit program plans adapt to those risks (Allen et al. 2006; Mock and Wright 1999). Unless auditors also take other offsetting actions, greater tolerance for misstatements in disclosed information could be a more risky strategy than realized.

The remainder of the paper is organized as follows: Section II develops the hypotheses. Sections III and IV describe the experimental method and results, respectively. Section V summarizes and discusses implications and directions for future research.

II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

Because we place our investigation of management credibility within the context of prior research on disclosure, recognition, and reconciliation of lease obligations, we begin with a brief review of the background literature on those issues. We then discuss prior research on management credibility and develop our hypotheses.

Disclosure, Recognition, and Reconciliation of Lease Obligations

Prior research on the consequences of management's choice to recognize or disclose accounting information when both conform with GAAP has focused on investment implications, primarily for capital market participants and to a lesser extent for creditors or lenders.² With few exceptions (e.g., Libby et al. 2006), the impact beyond the immediate investment setting has been largely ignored, despite the likely ramifications for others, especially auditors.

Current GAAP requires disclosure for operating leases and recognition for capital leases (SFAS No. 13; IAS 17), but standard setters (IASC 2000), regulators (SEC 2005), and sophisticated users (e.g., Imhoff et al. 1991; Revsine et al. 2002; Houlihan and Sondhi 1984; S&P 2006) have indicated they believe *all* leases should effectively be recognized (see also Nelson and Tayler 2007). Because the risk of investing in a company increases with the level of its debt (e.g., Piotroski 2000), users' perceptions of the risk of investing in a company should therefore increase with the amount of lease obligations, regardless of the accounting treatment.

² For examples with equity investors, see Amir and Ziv (1997), Barth et al. (2003), Beattie et al. (2000), Cotter and Zimmer (2003), Davis-Friday et al. (1999, 2004), Entwistle (1999), Espahbodi et al. (2002), Frederickson et al. (2006), Harper et al. (1987), Imhoff et al. (1993), and Munter and Ratcliffe (1983). For examples with debt investors, see Gopalakrishnan and Parkash (1996), Harper et al. (1991), Wilkins (1984), and Wilkins and Zimmer (1983a).

Supplemental disclosure of minimum future lease payments provides users with the information needed to approximate the balance sheet and income statement as if disclosed leases had been recognized. However, this ‘constructive capitalization’ adjustment is reasonably difficult. The effort and attention required also reduces the likelihood that users will attempt the adjustment (Bloomfield 2002; Hirshleifer and Teoh 2003; Hirst et al. 2003; Hunton et al. 2006). Consistent with these lines of reasoning, prior research provides evidence that recognized debts have a stronger influence on investors’ judgments than does disclosed debt information. Investors are more likely to view obligations as a form of debt if they are recognized rather than disclosed (Harper et al. 1987, 1991; Gopakakrishnan and Parkash 1996), leading investors to be more likely to invest in a company that has lower recognized debt (Munter and Ratcliffe 1983). Similarly, bank analysts’ risk assessments are affected more by recognized than disclosed information (Hirst et al. 2004). Thus, even though knowledgeable users have clearly stated their preference for lease recognition, financial statement users in general are less likely to consider a higher debt basis and assess higher investment risk when debts such as lease obligations are merely disclosed.³

Consistent with investors’ greater focus on recognized amounts, Libby et al. (2006) find that auditors are willing to allow greater misstatement in disclosed amounts than in recognized amounts. Specifically, they examine audit partners’ decisions regarding how much of an understatement in stock option compensation or lease obligations should be corrected, finding that partners knowingly require less correction when items are disclosed rather than recognized.

³ As discussed, we apply the lease obligation setting because it combines several features useful in isolating causes and consequences of users’ differential inferences about management credibility: reporting flexibility, a directional difference between management’s and sophisticated users’ preferences, and a reconciliation process requiring additional knowledge. We leave it to other researchers to investigate additional questions about the market’s ability to efficiently incorporate sophisticated users’ understanding of disclosed lease information into stock prices (e.g., Ge 2006; see Lipe 2001 for a review).

Auditors' differential treatment may be a rational response to differences in the risk of litigation or reputation loss (Libby et al. 2006, 535). If financial market participants place *less* weight on disclosed information than on recognized information, auditors may appropriately perceive lower risk in disclosed amounts than in recognized amounts, establishing higher materiality levels and tolerating greater levels of misstatement.

Nelson and Tayler (2007) find that knowledgeable users can weight disclosed lease obligations *more* heavily than recognized information, indicating potential circumstances under which that reasoning may not be appropriate. Specifically, participants in their experiment were experienced enough to understand and apply a constructive capitalization adjustment to the company's disclosed lease obligations, and they either prepared their own reconciliation or received an experimenter-prepared reconciliation of the lease disclosure to recognition. Both procedures involve a reconciliation from a source independent of company management (i.e., the participant's own efforts or the experimenter). If users do not give reduced weight to disclosed information, then the assumption of lower litigation risk may not hold. Further, if lower assessments of management credibility lead users to increase their expectations of the skepticism or effort that should have been applied by the company's auditor, the business risk associated with disclosed amounts could increase relative to recognized amounts.

Relatedly, Elliott (2006) investigates the effect of a voluntary management-provided reconciliation in a different context: from pro forma earnings to GAAP earnings when pro forma earnings were emphasized by management. Because pro forma earnings are higher than GAAP earnings, providing a reconciliation acts against management's typical incentives. Although not hypothesized, Elliott finds that a management-provided reconciliation leads financial analysts to view pro forma earnings as more reliable and to increase their weighting of pro forma earnings when judging earnings performance. For nonprofessional participants, Elliott finds that the

reconciliation reduces the influence of pro forma earnings on users' earnings performance judgments, with no significant difference in perceived reliability. Her findings suggest that a supplemental reconciliation of alternative accounting treatments affects users' perceptions of credibility contingent on their level of sophistication. We therefore assess the effects of users' understanding of the financial impact of the accounting treatment separately from the credibility inferences they might make based on management's accounting choices.

Management Credibility

Mercer (2004, 186) notes that much of the financial accounting literature has focused on 'disclosure credibility,' defined as financial statement users' perceptions of the believability of a particular disclosure. The credibility of a company's financial disclosures can vary with a number of factors, including management's incentives at the time of the disclosure, various characteristics of the disclosure itself (e.g., precision, venue, timing, completeness, and inherent plausibility), the degree of external and internal assurance available, and the existing overall level of 'management credibility,' defined as financial statement users' beliefs about management's trustworthiness and competence (Mercer 2004; Hirst et al. 2007b). This description is similar to Birnbaum and Stegner's (1979) characterization of source credibility in terms of source bias and source expertise.

Prior research has also documented that some aspects of disclosure credibility (e.g., completeness—Mercer 2005; timing—Libby and Tan 1999; accuracy—Tan et al. 2002 and Williams 1996) impact users' assessments of management credibility, at least in the short term. We posit that users' credibility assessments (particularly, of management trustworthiness) are also affected by their awareness of management's incentives. Hirst et al. (1995) find that financial statement users perceive incentive-consistent information as less credible than incentive-inconsistent information. Extending this finding, Hodge et al. (2006) document that users' assessments of the credibility of management's classification choices rely less (more) on

the consistency with management's incentives in a mandated (discretionary) reporting environment. Hodge et al. also show that users' assessments of the credibility of management's classification choices rely less (more) on consistency with management's incentives when management has already established a good (poor) overall reporting reputation.

Persuasion models developed in psychology and accounting indicate that perceived situational incentives can influence both disclosure credibility and management credibility. People attribute an incentive-consistent message to the source's incentives, but attribute an incentive-inconsistent message to the source's underlying beliefs (e.g., Kelley 1972). Therefore, disclosures consistent with management incentives are less likely to be believed (Mercer 2004), and management credibility assessments increase when management is forthcoming about negative news relative to when management is not forthcoming (Mercer 2005).

Thus, when a supplemental disclosure acts against management's incentives (as with a reconciliation that transforms disclosed lease obligations to appear as if recognized), we expect users to perceive higher management credibility when management provides that additional information (similar to Hirst et al. 2007a in the context of management forecasts), but lower management credibility when users are aware that management has not provided them with that information (similar to Nelson and Tayler 2007). We argue that when management provides the reconciliation, users are more likely to perceive management as being forthcoming and honest, affecting the 'trustworthiness' component of management credibility.⁴ In contrast, when it is clear that management has opted not to provide that information (e.g., when users have enough knowledge to prepare their own reconciliation, or when they receive the reconciliation from an outside source), users are less likely to perceive management as forthcoming and honest.

⁴ The positive effect of the management-provided reconciliation would be offset to the extent that users are also prompted to question why management did not simply recognize the lease obligations directly in the financial statements. The direction of the resulting net effect is therefore uncertain.

Therefore, we anticipate that users' assessments of management credibility will be lower when a source other than company management has provided that reconciliation.

H1a: When an independent source provides a supplemental reconciliation transforming disclosed lease obligations to appear as if recognized, users will assess *lower* management credibility than when the same reconciliation is provided by management.

In H1a, we focus on a situation in which alternate sources have opted to provide the identical reconciliation in order to control for users' understanding of the financial impact of the accounting treatment. Recognition of lease obligations in the financial statements is also inconsistent with management's typical incentives, but we do not anticipate a similar effect on management credibility. Individuals are unlikely to fully appreciate omitted information and will therefore likely overestimate the exhaustiveness of the analysis (Fischhoff et al. 1978; Hunton et al. 2006). Thus, between the recognition and disclosure control conditions, we expect participants will generally not recognize that information (i.e., reconciliation from disclosure to recognition) is missing, will be unlikely to realize a constructive capitalization adjustment would have been worthwhile, and thus will provide similar management credibility ratings.

H1b: When lease obligations are disclosed (without a supplemental reconciliation), users will assess *similar* management credibility as when lease obligations are recognized.

Management Credibility Consequences

Investment Risk

Prior accounting research has documented that management's disclosure policy can have a substantial impact on financial statement users' expectations for a company's cost of equity capital and stock price (Francis et al. 2005; Healy et al. 1999; see also Bloomfield and Wilks 2000), as well as its cost of debt (Francis et al. 2005; Sengupta 1998). Analysts' assessments of corporate disclosure quality tend to be higher for companies that are larger, have better financial performance, and have recent or upcoming security issuances (Lang and Lundholm 1993).

Companies for which analysts have assessed higher disclosure quality also enjoy a larger analyst following, with more accurate analyst earnings forecasts, less dispersion among individual analyst forecasts, and less volatility in forecast revisions (Lang and Lundholm 1996). Therefore, if the presentation of a supplemental reconciliation that transforms disclosed lease obligations to appear as if recognized leads users to consider management incentives and affects perceptions of management credibility, we also expect to observe that users' assessments of investment risk are higher when an independent source provides the reconciliation.

H2a: When an independent source provides a supplemental reconciliation transforming disclosed lease obligations to appear as if recognized, users will perceive *higher* investment risk than when the same reconciliation is provided by management.

H2a follows naturally from the extant financial accounting literature and is in keeping with Nelson and Tayler's (2007) finding that knowledgeable users weight disclosed information *more* heavily than recognized information when they either prepared their own reconciliation or received an experimenter-prepared reconciliation. However, while the disclosure of minimum future lease payments provides the information needed to approximate the balance sheet and income statement as if disclosed leases had been recognized, the 'constructive capitalization' adjustment is reasonably difficult and effortful, such that only relatively knowledgeable users are likely to attempt it spontaneously. We therefore expect that our participants will weight disclosed information *less* heavily when no supplemental reconciliation is available.

H2b: When lease obligations are disclosed (without a supplemental reconciliation), users will assess *lower* investment risk than when lease obligations are recognized.

Support for H2b would suggest that participants in our control groups are responding to differences in the case materials, even if they assess similar levels of management credibility (as in H1b). Thus, unlike for participants in our treatment conditions (as in H2a), the increased risk assessments should not be mediated by users' assessments of management credibility.

Audit Expectations

The National Commission on Fraudulent Financial Reporting (Treadway Commission 1987, 32) asserts that “the tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most important factor contributing to the integrity of the financial reporting process.” Assessments of the control environment and ‘tone at the top’ remain critical for the auditor (COSO 1994; AICPA 2006). Although the existence of an audit ‘expectation gap’ is long established (e.g., Cohen Commission 1978; Libby 1979), relatively little research has looked at the interactions between auditors and the expectations of financial statement users beyond the wording or format of the audit report, perceived auditor independence (especially with respect to non-audit services), and litigation-related issues involving ambiguity, hindsight bias, or expert-witness testimony (see Nelson and Tan 2005 and Trotman 2005 for relevant discussions). However, concerns about disclosure credibility (Mercer 2004, 185) and the importance of ‘closing’ the audit expectations gap (Zhang 2007, 632) appear to have increased along with the development of new audit regulations in response to recent financial scandals such as Enron and WorldCom.

We posit that users’ expectations of the company’s auditor will mirror their assessments of management credibility. Although the standard of care expected of the auditor should be based on *ex ante* factors in evaluating the sufficiency of audit work, this does not always occur. For example, jurors may assess higher standards of care for the auditor when the *ex post* consequences of an audit failure are severe (Kadous 2000). A similar concern is applicable in our setting. Transactions can be structured so as to allow different accounting treatments under GAAP (Abdel-khalik 1981; Imhoff et al. 1991; see also Nelson et al. 2002), and reconciliations are not required in this setting. Nevertheless, because of the effects on users’ assessments of management credibility, similar effects may be observed in users’ audit expectations.

In other words, if users have *ex post* concerns about management credibility, they may expect auditors to have shared those concerns *ex ante* and to have planned their audit work accordingly. Psychology research suggests that people tend to overestimate the commonality of their own knowledge and beliefs (Nickerson et al. 1987; Keysar et al. 1995; Van Boven et al. 2003; see Marks and Miller 1987 for a review of the false consensus effect). Thus, we examine whether users' judgments of management credibility extend to their expectations for the auditor.

H3a: When an independent source provides a supplemental reconciliation transforming disclosed lease obligations to appear as if recognized, users will report *higher* audit expectations than when the same reconciliation is provided by management.

Because we anticipate that, without reconciliation, users will provide similar management credibility ratings between the disclosure and recognition control conditions, we also anticipate that users will report similar audit expectations between these control conditions.

H3b: When lease obligations are disclosed (without a supplemental reconciliation), users will assess *similar* audit expectations as when lease obligations are recognized.

III. EXPERIMENT

Participants

Participants are undergraduate students recruited from a junior-level managerial accounting course at a large public university who completed the study for extra course credit. Participants attended one of fifteen experimental sessions, and were randomly assigned to the between-subject conditions within each session.

We purposefully recruit participants with relatively limited accounting knowledge, so that we can add to their knowledge through our experimental manipulations (as discussed further below). Separating the effects of users' understanding of the financial impact of the accounting treatment from the credibility inferences they might make based on management's accounting choices is important because prior research suggests perceptions of credibility are contingent on

users' level of sophistication (Elliott 2006). Although existing knowledge cannot be removed from more sophisticated users (such as the participants in Nelson and Tayler 2007), we can assess its effects by enhancing the understanding of less sophisticated users (such as our participants).^{5,6}

Method

Design

We adapt Nelson and Tayler's (2007) materials to a 1×4 between subjects design, manipulating the financial disclosures for a company's leases in two treatment and two control conditions. In our two treatment conditions, the company discloses its lease obligations, and we manipulate the *source* of a reconciliation of the lease disclosure to constructive capitalization. Specifically, participants initially receive the company's financial information, including footnote disclosure of the lease obligations. Participants later receive a supplemental reconciliation indicating what the company's financial results would have been if the disclosed leases had instead been recognized in the financial statements. The source of the reconciliation is manipulated to be either (1) an independent research analyst, or (2) company management.

We complement our two treatment conditions with two control conditions in which participants do not receive any supplemental reconciliation. In the first control condition, participants only receive the company's financial information, which includes footnote disclosure of the lease obligations; we refer to this as the disclosure control group. In the second control condition, participants only receive the company's financial information, but the company has

⁵ An alternative would be to compare groups of participants with different degrees of sophistication (e.g., students and financial analysts, as in Elliott 2006). Even so, using an observed (rather than manipulated) partitioning imposes other trade-offs, being "subject to the same correlated-omitted variables problems that compromise internal validity in archival research" (Libby et al. 2002, 798).

⁶ Prior research suggests that the completion of an undergraduate auditing class significantly shifts students' audit expectations closer to those of practicing auditors, reducing (Gramling et al. 1996; Monroe and Woodliff 1993) or possibly closing (Frank et al. 2001) the expectation gap. At this stage of their studies, our participants would not yet be enrolled in an auditing class, but it remains possible that such views could develop earlier in their studies or be intrinsic to accounting students. The extent to which our participants are more knowledgeable or share more sophisticated financial views should bias against finding our predicted pattern of results.

recognized its lease obligations in the financial statements instead of merely disclosing them in the footnotes; we refer to this as the recognition control group. In all conditions, the lease footnote provides identical information, sufficient for knowledgeable users to constructively capitalize the leases (or reverse the lease recognition, if they wish to do so).

Dependent Measures

Our dependent measures include management credibility, investment risk, and audit expectations. We ask all participants to evaluate each of the three dependent measures in order to facilitate mediation analyses.⁷ Participants assess the dependent measures on 11-point Likert scales. Specifically, participants assess investment risk (i.e., how the risk of investing in the company's long-term debt compares to the industry in general) using a response scale anchored at 0 (much less risk than average) and 100 (much more risk than average), scored in 10-point increments. Similarly, participants assess management credibility (i.e., how credible [trustworthy or believable] management is likely to be compared to the management of other companies in the industry) using a response scale anchored at 0 (much less credible than average) and 100 (much more credible than average). Finally, participants assess their level of concern that the financial statements contain potential material misstatements both (1) overall, and (2) with respect to the leases held by the company, using response scales anchored at 0 (much less risk than average) and 100 (much more risk than average).⁸ We use the mean of these two judgments

⁷ Dependent measures were collected in a single order (investment risk, management credibility, then audit expectations). We collect additional data to assess the potential effect of asking participants about management credibility immediately prior to reporting their audit expectations, and discuss this issue further in a later section.

⁸ Specifically, participants were instructed that, when evaluating a company's financial statements, "auditors need to assess the risk (called audit risk) that the financial statements contain material misstatements that they [the auditors] might fail to detect" and that "such misstatements could occur through either error (which is unintentional) or fraud (which is intentional) on the part of the company." Although we generically label this as 'audit risk' in the materials, we do not address or attempt to inform participants of the potential interactions among the components of the audit risk model. To the extent that auditors' judgments of management credibility are similarly affected, they would likely adjust their audit work to compensate for the increased assessments of control risk; we leave this question open for future research.

as our measure of participants' audit expectations.⁹ For ease of interpretation, we divide by 100 and present all dependent measures on a percentage basis.

Participants provide both initial and revised assessments of each of the dependent measures. Participants provide initial assessments after first viewing excerpts from the company's financial statements, which include footnote disclosure of the lease obligations. Participants provide revised assessments after being asked to review a duplicate of the initial financial information and, if applicable, the supplemental reconciliation. Similar to Hirst et al. (1999) and Sedor (2002), we examine the least squares adjusted means for participants' revised responses, after adjusting for initial responses using analysis of covariance (ANCOVA).¹⁰

To provide corroborating evidence with alternative measures, we also analyze participants' responses to post-task questions about their credibility assessments and the auditors' responsibilities. In our post-task questions, we asked participants to assess their level of agreement with adaptations of Mercer's (2001, 2005) trustworthiness and competence components of management credibility.¹¹ We also asked participants to provide further assessments of the auditors' responsibilities with respect to the application of effort, care, and skepticism while auditing the company.¹²

⁹ Inferences are unchanged when we reanalyze our hypotheses using either of the two individual measures.

¹⁰ Inferences are unchanged when we reanalyze our hypotheses after omitting the 'initial response' covariate.

¹¹ The three trustworthiness statements are: (1) Company management is very trustworthy, (2) Company management is very honest; and, (3) Company management is not truthful in their financial disclosures. The final statement ("not truthful") is reverse-scored. The three competence statements are: (1) Company management is very competent at providing financial disclosures; (2) Company management has poor knowledge of the factors involved in providing disclosures; and, (3) Company management is highly qualified to provide financial disclosures about the Company. The second statement ("poor knowledge") is reverse-scored.

¹² The four items are as follows (with emphasis in the original): (1) Compared to a typical audit, how much can P.F. Chang's auditors **rely** on Company management for full and complete information while auditing the Company?; (2) Compared to a typical audit, how much **effort** do P.F. Chang's auditors need to put into auditing the Company?; (3) Compared to a typical audit, how **careful** do P.F. Chang's auditors need to be while auditing the Company?; and, (4) Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. Compared to a typical audit, what level of **professional skepticism** do P.F. Chang's auditors need to apply while auditing the Company? The first item ("rely") is reverse-scored.

Procedures

The experiment is administered in two envelopes. In envelope A, participants read background information about P. F. Chang's China Bistro, Inc., a company which operates a nationwide chain of restaurants. The background information includes a brief company description, a condensed description of the two possible methods of accounting for leases, a statement indicating the method applied by the company, and a description of two common financial ratios (specifically, the debt-to-equity ratio and the cash-flows-from-operations-to-debt ratio). In order to convey the 'choice' of accounting method, all participants are informed that companies can structure contracts so as to select from two alternative methods under GAAP. Then, participants review the company's financial information (which consists of excerpts from the financial statements, the two financial ratios along with industry comparatives,¹³ and the lease footnote). Figure 1 presents these materials for the experimental treatment and disclosure-control conditions in Panel A and for the recognition-control condition in Panel B. Next, participants answer two comprehension check questions to verify their understanding of the acceptable methods of accounting for leases under GAAP and the method that was applied by the company. Participants provide their initial assessments of the dependent measures (investment risk, management credibility, and audit expectations) and return the case materials to envelope A before proceeding.

Envelope B contains duplicates of the background and financial information from envelope A for the participant's reference. Participants assigned to the two treatment conditions then receive the supplemental reconciliation with the source manipulation (see Figure 1, Panel C), and answer additional comprehension check questions to verify their understanding of the

¹³ Nelson and Tayler's (2007) materials contain information for two firms, P.F. Chang's (on which we base our materials) and a competitor. In our materials, we present the competitor's ratios as the industry averages, which allows us to eliminate an alternative explanation for why our results might otherwise differ from theirs.

source of the reconciliation and the effect of the capitalization adjustment on the financial ratios. Next, all participants again provide their assessments of the dependent measures, responding to the same questions listed in envelope A.

Following their revised assessments of the dependent measures, participants answer corroborating questions about their credibility assessments and the auditors' responsibilities, as well as an opinion question about the appropriateness of the alternate accounting methods. Finally, participants complete the session by answering demographic questions.

IV. RESULTS

Comprehension Checks

All participants responded to two comprehension check questions after reviewing the initial financial information to verify their understanding of (1) the acceptable methods of accounting for leases and (2) the method applied by the company in its financial statements. Participants in the two treatment conditions also responded to additional comprehension check questions after receiving the supplemental reconciliation to verify their understanding of (1) the source of the reconciliation, and (2) the impact that recognition would have on both of the two financial ratios presented. For each separate question, nearly all participants (minimum of 95.3 percent) responded correctly. Our analyses are based on the 95 participants who correctly answered all applicable comprehension check questions.¹⁴

¹⁴ Participants in the control conditions were not asked the additional comprehension check questions. Across all four conditions, the proportion of participants who did not pass all of the comprehension check questions varies significantly (two-sided $p=0.007$ under Fisher's Exact Test). This difference is likely caused by the greater number and difficulty of the comprehension check questions in the treatment conditions. Importantly, the proportion of participants who did not pass does not vary significantly between the two treatment conditions (two-sided $p=0.294$ under Fisher's Exact Test). The effect of reconciliation source on investment risk (H2a) weakens from marginal to non-significant when we instead analyze responses from all available 106 participants; however, the significance of reconciliation source on management credibility (H1a) and audit expectations (H3a) remains unchanged.

Tests of Hypotheses

Table 1, Panel A reports descriptive statistics for each of our dependent measures, including means and least squares adjusted means for participants' management credibility, investment risk, and audit expectations. Figure 2 graphs the adjusted means, and Table 1, Panel B summarizes the planned comparisons used to test our hypotheses.

Management credibility

H1a predicts that participants who receive a reconciliation of the disclosed lease obligations to constructive capitalization will view management as less credible when the reconciliation is provided by an independent source rather than company management. In support of H1a, participants who received the analyst reconciliation view management as significantly less credible than do participants who received the management reconciliation ($t = -2.64$, $p = 0.005$).¹⁵

H1b predicts that participants are unlikely to differ in their views of management credibility without the presence of a reconciliation. In support of H1b, participants in the disclosure control group do not view management credibility significantly differently from those in the recognition control group ($t = +0.42$, two-sided $p = 0.672$).

Analyses also suggest that the presence of a salient reconciliation from an independent source lowers participants' views of management credibility relative to recognition alone. Participants who received the analyst reconciliation view management as significantly less credible than do participants in the recognition control group ($t = -4.52$, two-sided $p = <0.001$), while participants who received the management reconciliation view management as only marginally less credible ($t = -1.86$, two-sided $p = 0.066$).¹⁶

¹⁵ We report one-sided p-values unless otherwise indicated.

¹⁶ Along with participants' assessments of the dependent measures (management credibility, investment risk, and audit expectations), we also asked participants to assess the amount of incentive that management has to choose one method of accounting for leases instead of the other, on an 11-point Likert scale anchored at 0 (no incentive)

(Continued)

To corroborate that participants' inferences about management credibility are related to their perceptions of trustworthiness rather than competence, we asked participants to assess their level of agreement with adaptations of Mercer's (2001, 2005) trustworthiness and competence components of management credibility (see footnote 11). Taking the mean of each set of statements, we observe that participants' revised credibility assessments appear more strongly positively correlated with trustworthiness ($r = +0.422$, $p < 0.001$) than with competence ($r = +0.215$, $p = 0.018$). A factor analysis of the individual items confirms the identification of two factors (eigenvalues of 2.94 and 1.15 with all other eigenvalues less than 1) that cumulatively explain 68 percent of the variance in the measures. Using the rotated factor analysis scores, we find that participants' revised credibility assessments are significantly positively correlated with the trustworthiness factor ($r = +0.451$, $p < 0.001$) and not with the competence factor ($r = -0.037$, two-sided $p = 0.722$). We find that the significance of reconciliation source in H1a and H1b is unchanged when we measure credibility using the participants' mean rating of the three trustworthiness statements or using the factor score for trustworthiness.

Investment Risk

H2a predicts that participants who receive a reconciliation of the disclosed lease obligations to constructive capitalization will perceive higher investment risk when the reconciliation is provided by an independent source rather than by company management. In support of H2a, participants who received the analyst reconciliation perceive marginally higher investment risk than participants who received the management reconciliation ($t = +1.49$, $p = 0.070$).

and 100 (high incentive). Analyses (untabulated) confirm that participants are only likely to consider management's incentives when prompted to do so by the presence of a reconciliation. Participants in the two treatment conditions perceive higher incentive levels than participants in the two control conditions ($t = +9.50$, two-sided $p < 0.001$), but participants who received the analyst reconciliation perceive similar incentive levels as those who received the management reconciliation ($t = +0.45$, two-sided $p = 0.651$).

H2b predicts that disclosed information affects judgments less than recognized information. In support of H2b, participants in the disclosure control group perceive significantly lower investment risk than do participants in the recognition control group ($t = -3.00$, two-sided $p = 0.004$), supporting a necessary assumption for auditors to reasonably conclude that litigation risk is lower for disclosed amounts (Libby et al. 2006).

Analyses also suggest that the presence of a reconciliation from an independent source tends to increase perceived investment risk relative to recognition alone. Participants who received the analyst reconciliation perceive significantly higher investment risk than did participants in the recognition control group ($t = +2.59$, two-sided $p = 0.011$), while participants who received the management reconciliation do not ($t = +1.34$, two-sided $p = 0.185$).

Audit Expectations

H3a predicts that participants who receive a reconciliation of the disclosed lease obligations to constructive capitalization will also expect more from the auditor when the reconciliation is from a source other than company management. In support of H3a, participants who received the analyst reconciliation report significantly higher audit expectations than do participants who received the management reconciliation ($t = +3.43$, $p < 0.001$).

Mirroring the results with management credibility, H3b predicts that participants are unlikely to differ in their audit expectations without the presence of a reconciliation. In support of H3b, participants in the disclosure control group do not report significantly different audit expectations from those in the recognition control group ($t = -0.74$, two-sided $p = 0.464$).

Analyses also suggest that the presence of a salient reconciliation from an independent source raises audit expectations relative to recognition alone. Participants who received the analyst reconciliation report significantly higher audit expectations than did participants in the recognition control group ($t = +5.21$, two-sided $p < 0.001$), while participants who received the

management reconciliation do not ($t = +1.60$, two-sided $p = 0.114$). Consistent with Nelson and Tayler's (2007) weighting evidence, these findings suggest that independent reconciliation may create conditions in which audit expectations are *higher* (and, in turn, auditors' litigation risk may also be higher) for disclosed information than for recognized information.

In post-task questions, we asked participants to provide additional assessments of the auditors' responsibilities with respect to the application of effort, care, and skepticism while auditing the company (see footnote 12). A factor analysis of the individual items results in the identification of a single 'standard of care' factor (eigenvalue of 2.64 with all other eigenvalues less than 1) that explains 66 percent of the variance in the measures (Cronbach's alpha = 0.819). Participants' revised audit expectations (whether overall, specific to leases, or combined) are significantly positively correlated with this standard of care construct, whether measured using the mean assessments across statements (smallest $r = +0.448$, largest $p < 0.001$) or the first factor score (smallest $r = +0.439$, largest $p < 0.001$). We find that the significance of reconciliation source in H3a and H3b is unchanged when we measure audit expectations using the participants' mean ratings of the statements or using the factor scores.¹⁷

Mediation

In developing our hypotheses, we imply that management credibility mediates the differences in audit expectations caused by the reconciliation source. We therefore apply a path analysis to simultaneously estimate the predicted direct and indirect relationships among the variables, as presented in Figure 3. For simplicity, we focus on our treatment conditions, and

¹⁷ Analyses of the remaining post-task questions (untabulated) suggest that the differences we observe in audit expectations are not likely to be caused by differences in participants' beliefs about how to determine an appropriate standard of care. Also consistent with the presentation of a reconciliation highlighting management's incentives to prefer disclosure over recognition, participants in the two treatment conditions (who received a reconciliation) view disclosure as relatively less appropriate than recognition compared to participants in the two control conditions.

estimate the coefficients for participants who received the analyst reconciliation relative to those who received the management reconciliation.

We find results consistent with our hypotheses and mediation assumptions (Figure 3, Panel A). First, and most importantly, we observe that participants who received the analyst reconciliation view management as less credible than do participants who received the management reconciliation ($-0.140, z = -2.24$);¹⁸ in turn, participants who view management as less credible also expect more from the auditor ($-0.411, z = -4.27$). Second, we observe that participants who received the analyst reconciliation tend to perceive higher investment risk, but this tendency occurs indirectly through lower perceived management credibility ($-0.233, z = -1.25$) rather than through a direct effect of reconciliation source ($+0.070, z = +0.88$). We also find evidence that the higher investment risk will also lead to increased audit expectations ($+0.182, z = +2.25$).

Because of potential ‘lack of fit’ in the model, we replicate the analyses using the rotated factor scores for trustworthiness and standard of care, and we find similar results (Figure 3, Panel B).¹⁹ We also perform a mediation analysis (Baron and Kenny 1986; Kenny et al. 1998) of management credibility on the effect of reconciliation source on audit expectations. Results (untabulated) confirm that the effect of the reconciliation source is reduced, indicating partial

¹⁸ The critical ratios are asymptotic z-statistics, computed as the path coefficient estimates divided by their respective standard errors. While their asymptotic distribution is normal, their exact sampling distribution is unknown. We therefore do not report precise p-values, but suggest that these statistics be interpreted relative to the critical z value of 1.64 (1.28) for one-sided tests at 5% (10%). As well, the links within the model are estimated using maximum likelihood estimation techniques, with similar results using generalized least-squares estimation.

¹⁹ Using a chi-square test, the null hypothesis that the model in Figure 3, Panel A ‘fits the data’ is rejected ($\chi^2_1=9.09, p = 0.003$). Additional goodness of fit indices, namely Bentler and Bonett’s normed fit index (NFI=0.771) and non-normed fit index (NNFI=-0.444), as well as Bentler’s comparative fit index (CFI=0.759), also indicate a lack of fit (i.e., with values < 0.90; Hatcher 2005). However, when we reanalyze the model using the rotated factor scores for trustworthiness and standard of care (Figure 3, Panel B), we no longer find any significant evidence of lack of fit ($\chi^2_1=0.960$ with $p = 0.327$; NFI = 0.982; NNFI = 1.005; CFI = 1.000).

mediation. The effect of the reconciliation source is eliminated when we replicate the analyses using the factor scores for trustworthiness and standard of care.

We also repeat the path analyses (untabulated) for our two control conditions. We find that recognition (relative to disclosure) significantly increases perceived investment risk, but this tendency occurs as a direct effect of recognition (+0.342, $z = +5.69$) rather than indirectly through lower perceived management credibility (-0.024 , $z = -0.51$). These analyses confirm that our participants are unlikely to differ in their views of management credibility without the presence of a reconciliation, again supporting a key assumption for auditors to reasonably conclude that litigation risk is lower for disclosed amounts (Libby et al. 2006).

Additional Data

We conduct a partial replication of our study in order to assess the potential demand effect of asking participants about management incentives and credibility immediately prior to their audit expectations. Additional participants are undergraduate students recruited from the next offering of the same junior-level managerial accounting course who completed the study for extra course credit. We limit our design to the experimental treatment conditions in which reconciliation source is manipulated (independent analyst or company management). Between subjects, we also manipulate whether participants are asked the full set of dependent measures (i.e., management credibility, investment risk, and audit expectations) or a partial set in which the potentially leading 'management credibility' questions are omitted. However, to ensure that we can retest the mediation analyses, all participants are still asked to respond to the same post-task questions about management credibility and auditor responsibilities. In order to provide preliminary evidence on litigation risk, we ask participants to consider the hypothetical discovery

of an error in the audited financial statements in a new post-task question,²⁰ and we counter-balance the order of this question (before versus after the post-task questions on management credibility and auditor responsibilities). Procedures were otherwise identical to the original study, and we similarly limit our analyses to the 101 participants who correctly answered all comprehension check questions.²¹

We analyze participants' revised audit expectations as a function of reconciliation source (analyst or management), question set (full or partial), counterbalanced order (before or after), and the two- and three-way interactions, after controlling for their initial audit expectations. In untabulated analyses, we find no significant effect of the question set, order, or interactions (all two-sided $p > 0.258$), with participants who receive the analyst reconciliation reporting marginally higher audit expectations than participants who receive the management reconciliation ($t = +2.34$, $p = 0.065$). When we measure audit expectations using participants' mean rating of the post-task auditor responsibility statements or using the factor score, the source effect strengthens (both $p < 0.014$). This replicates the primary finding from the original study.

We then replicate the path analyses from the original study using the factor scores for trustworthiness and standard of care (Figure 3, Panel C), extending the path to participants' reported concerns about whether the auditors met their professional responsibilities with the hypothetical error (see footnote 20). We observe lower explanatory power, but otherwise similar

²⁰ Adapted from Libby et al. (2006), participants were asked: "Some new leases at a consolidated subsidiary were accidentally omitted when the Company prepared their balance sheet and lease footnote, such that the present value of the lease obligations was understated by \$17.5 million. Thus, the present value of future lease payments should have been \$199,250, instead of \$181,750 as originally disclosed in the footnote. On a percentage basis, the omission is equal to 4.6% of the total assets reported on the balance sheet. Given the error, how concerned are you that P. F. Chang's auditors did not perform enough audit work to meet their professional responsibilities for this audit?" Responses are reported on an 11-point Likert scale from 0 (not at all concerned) to 100 (extremely concerned).

²¹ The proportion of additional participants who did not pass all of the comprehension check questions does not vary significantly across conditions and, importantly, between the source manipulations (two-sided $p = 0.277$ and 0.857 under Fisher's Exact Test, respectively). However, the proportion of participants who did not pass all of the comprehension check questions (30.3 percent) is qualitatively higher than in our original study (10.4 percent).

results. Although the effect is small, we also observe that participants' higher audit expectations lead, in turn, to a statistically significant increase in concerns that the auditors did not meet their professional responsibilities given the later discovery of an error (+0.033, $z = +2.07$).²²

V. SUMMARY AND CONCLUSIONS

Motivated by renewed concerns over auditors' potential conflicts of interest and pressures to favor management (e.g., Moore et al. 2006; Nelson 2006), disclosure credibility (Mercer 2004, 185), and the importance of 'closing' the audit expectations gap (Zhang 2007, 632), we examine circumstances under which accounting disclosures affect users' assessments of management credibility and, in turn, their audit expectations. While auditors act as if they believe that litigation risk is lower for disclosed amounts than for recognized amounts (Libby et al. 2006), users who are able to clearly understand the differential impact of the two treatments may weight disclosed information more heavily (Nelson and Tayler 2007), which is inconsistent with lower risk. To the extent that users assess management as less credible for choosing to merely disclose information, their assessments may extend to their expectations of the auditors' applied standard of care.

In our experiment, we separate the effects of users' understanding of the financial impact of the accounting treatment (by manipulating the presence of a supplemental reconciliation) from the inferences users might make based on management's choice of accounting treatment and disclosures (by manipulating the stated source of the reconciliation). We find that participants who receive a reconciliation of the disclosed lease obligations to recognition report lower perceptions of management credibility, higher investment risk, and higher audit expectations when the reconciliation is provided by a source independent of management rather than by

²² The chi-square test ($\chi^2_4=5.997$, $p = 0.199$) and Bentler's comparative fit index (CFI=0.952) indicate acceptable fit. Bentler and Bonett's normed fit index (NFI=0.885) and non-normed fit index (NNFI=0.881) remain close to the suggested value of 0.90 for acceptable fit.

company management itself. Thus, for users who understand the financial impact of the accounting choices made by management, incentive-consistent choices lower perceptions of management credibility and increase perceived investment risk and audit expectations. The path analysis we apply to simultaneously estimate the predicted direct and indirect relationships among the variables supports these results, with management credibility mediating the effects observed for investment risk and audit expectations. These results suggest that users expect their assessments of management to have been shared by auditors and reflected in their audit work.

Comparisons with the control conditions confirm that disclosed information alone tends to affect judgments less than recognized information, supporting a key assumption for the conclusion that audit litigation risk is generally lower for disclosed amounts (Libby et al. 2006). Users are unlikely to differ in their views of management credibility or in their audit expectations unless prompted to do so (in our experiment, via a reconciliation that increases participants' understanding of the financial impact of the accounting choices made by management), again supporting the assumption. But, when that prompt comes from an outside source (rather than via management's own disclosures), users report lower perceptions of management credibility, higher investment risk, and higher audit expectations relative to control conditions, consistent with Nelson and Tayer's (2007) weighting evidence. These findings suggest boundary conditions in which audit expectations are *higher* (and, thus, auditors' litigation risk may also be higher) for disclosed information than for recognized information.

This paper offers three primary contributions. First, we extend research on recognition versus disclosure, and the critical roles played by users' financial understanding and awareness of management's reporting flexibility, by demonstrating the effects of the presence and source of reconciliation on management credibility judgments. The results will likely be of interest to managers because they indicate the potential impact of legitimate, within-GAAP accounting

choices on users' opinions of management and the risk of investing in the company when those choices become salient. The effects could, at least in short term evaluations, offset the perceived benefits of 'managing' earnings or debt information through disclosure.

Second, we extend research on the influence of managerial reporting discretion to expectations for audit planning and performance. Results suggest that users expect auditors to have shared their *ex post* concerns about how financial reporting decisions reflect on management trustworthiness, and to have adjusted their efforts accordingly. This effect provides confirming evidence that an auditor's business risk is likely to change with perceived management integrity (i.e., a key factor in the control environment). This effect also implies that auditors may need to assess managers' decisions not only in light of their conformity with rules-based GAAP, but also in light of how those decisions may be later perceived by financial statement users who generate audit expectations based on their assessments of managers.

Third, we extend research on the expectation gap and auditors' litigation risk as it relates to the standard of care to be observed for recognized versus disclosed amounts. Because disclosed amounts are expected to be given less attention than recognized amounts, auditors may act as if the litigation risk associated with them is lower (Libby et al. 2006). We find, however, that the impact of the external reconciliation on management credibility judgments leads, in turn, to an *increase* in users' expectations of auditor diligence (and thus a potential increase in auditors' risk exposure) for disclosed versus recognized amounts.

Results suggest that users' audit expectations can be affected even when management's choices conform with rules-based GAAP. The effect could be stronger in a litigation setting in which the financial impact of recognizing previously disclosed amounts would be made salient to jury members. Whether the audit expectation results we document in our current study extend

to jurors' litigation judgments (e.g., greater penalties for failure to identify errors in disclosed relative to recognized amounts) remains an empirical question.

Our study raises a number of other opportunities for future research. To the extent that auditors are aware of the business risk implications of managers' within-GAAP accounting choices, it is possible that auditors take other actions to offset increased risks. As Mock and Wright (1999) and Allen et al. (2006) note, the extant research suggests that auditors are sensitive to client risk factors (for example, in client-acceptance decisions), but finds mixed results with respect to whether audit program plans are adapted to those risks (see also Kizirian et al. 2005). Results of some research (e.g., Bedard and Johnstone 2004) suggest that auditors' responsiveness may have improved in recent years (Allen et al. 2006). While we focus on *users'* judgments of management credibility in light of managers' within-GAAP accounting choices, the effect of these choices on *auditors'* perceptions of management, and the subsequent effects on audit planning, represents an interesting avenue for future investigation, as does auditors' anticipation of other disclosure transparency issues and market anomalies.

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EXCERPTS FROM THE COMPANY'S FINANCIAL STATEMENTS:

P.F. Chang's China Bistro, Inc.
Summarized Financial Results
for the 2005 Fiscal Year

Income Statement

Sales	\$706,941
Pre-tax earnings	\$ 36,710
Net earnings	\$ 26,054

Balance Sheet

Total assets	\$383,515	Total liabilities	\$107,763
		Total equity	<u>\$275,752</u>
			\$383,515

<u>Cash Flows from Operations</u>	\$109,505
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Financial Ratios

Debt/Equity	$\frac{\$107,763}{\$275,752} \times 100 = 39.1\%$	<i>Industry Averages:</i> 97.0%
Cash flows from operations/Debt	$\frac{\$109,505}{\$107,763} \times 100 = 101.6\%$	13.5%

Footnote 8: Leases

The Company leases all of its restaurant properties. On average, the leases have an implicit interest rate of 8%, 22-year total lease lives, and are 50% expired. The Company's applicable tax rate is 35%.

Lease payments are recorded on an on-going basis. When a payment is made, it increases operating expenses on the income statement. Future lease payments will be at least (in thousands):

<u>Fiscal Year</u>	<u>Lease Payments</u>
2006	\$ 26,118
2007	26,764
2008	26,314
2009	25,902
2010	25,607
Thereafter	<u>147,350</u>
Total	<u>\$278,055</u>
Present value	<u>\$181,750</u>

Panel A: Financial information initially provided in both source treatment conditions and the disclosure control condition

FIGURE 1
Excerpts of materials.

EXCERPTS FROM THE COMPANY'S FINANCIAL STATEMENTS:

P.F. Chang's China Bistro, Inc.
Summarized Financial Results
for the 2005 Fiscal Year

Income Statement

Sales	\$706,941
Pre-tax earnings	\$ 36,710
Net earnings	\$ 26,054

Balance Sheet

Total assets	\$531,005	Total liabilities	\$289,513
		Total equity	<u>\$241,492</u>
			\$531,005

<u>Cash Flows from Operations</u>	\$109,505
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Financial Ratios

Debt/Equity	$\frac{\$289,513}{\$241,492} \times 100 = 119.9\%$	<i>Industry Averages:</i> 97.0%
Cash flows from operations/Debt	$\frac{\$109,505}{\$289,513} \times 100 = 37.8\%$	13.5%

Footnote 8: Leases

The Company leases all of its restaurant properties. On average, the leases have an implicit interest rate of 8%, 22-year total lease lives, and are 50% expired. The Company's applicable tax rate is 35%.

The present value of the future lease payments is recorded as debt on the balance sheet. When a payment is made, it decreases the debt on the balance sheet. Future lease payments will be at least (in thousands):

<u>Fiscal Year</u>	<u>Lease Payments</u>
2006	\$ 26,118
2007	26,764
2008	26,314
2009	25,902
2010	25,607
Thereafter	<u>147,350</u>
Total	<u>\$278,055</u>
Present value	<u>\$181,750</u>

Panel B: Financial information initially provided in the recognition control condition

FIGURE 1. Continued.

Investors may find it helpful to think about how a company's financial results would change if an alternative accounting method had been applied. Company management may choose to provide this type of additional report. If the Company chooses not to provide the report, an independent research analyst may step in to provide the report instead.

Company management has chosen not to provide that report for its investors. The information on the following page was prepared by an independent research analyst, and was included in the analyst's own research report about the Company.

OR

Company management has chosen to provide that report for its investors. The information on the following page was prepared by Company management, and was included in the Company's financial statements.

Page Break

Reconciliation: Alternative accounting for leases

This reconciliation shows how the Company's financial results would change if the alternative method of accounting for leases had been applied. Instead of recording lease payments on an on-going basis, the alternative method initially records the leased property as an asset and the present value of the future lease payments as debt on the balance sheet. Then, when a payment is made, it decreases the amount of the debt.

Adjustments to Balance Sheet

Total assets, without recognizing leases	\$383,515	Total liabilities, without recognizing leases	\$107,763
Add: Increase in assets	<u>147,490</u>	Add: Increase in liabilities	<u>181,750</u>
Total assets, after recognizing leases	<u>\$531,005</u>	Total liabilities, after recognizing leases	<u>\$289,513</u>
		Total equity, without recognizing leases	\$275,752
		Deduct: Decrease in equity	<u>34,260</u>
		Total equity, after recognizing leases	<u>\$241,492</u>

Adjusted Financial Ratios

	Without Recognizing <u>Leases</u>	After Recognizing <u>Leases</u>	<i>Industry Averages</i>
Debt/equity	39.1%	$\frac{\$289,513}{\$241,492} \times 100 = 119.9\%$	<i>97.0%</i>
Cash flows from operations/Debt	101.6%	$\frac{\$109,505}{\$289,513} \times 100 = 37.8\%$	<i>13.5%</i>

Panel C: Additional financial information subsequently provided in the two source treatment conditions, with the source of the reconciliation manipulated to be either (1) an independent research analyst, or (2) company management

FIGURE 1. Continued.

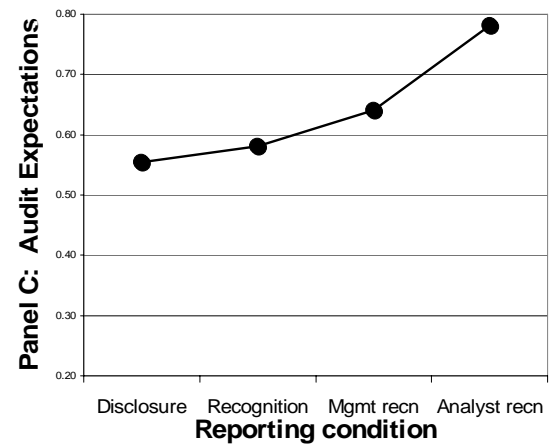
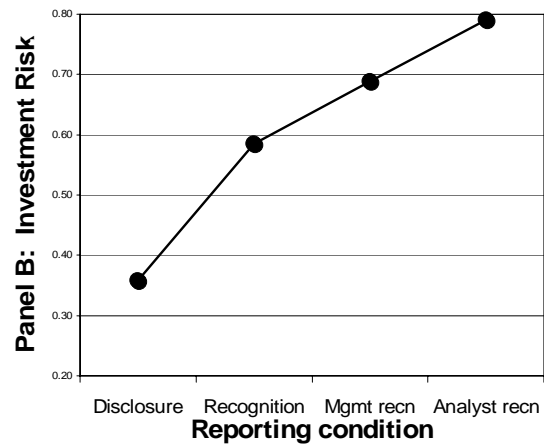
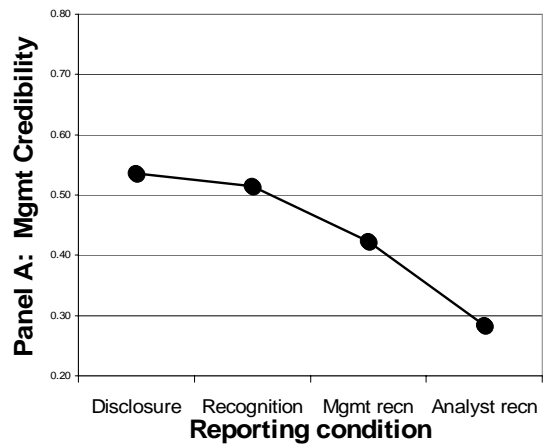
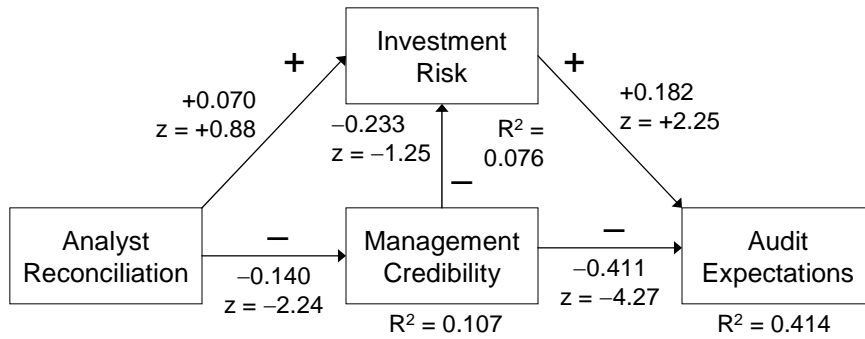
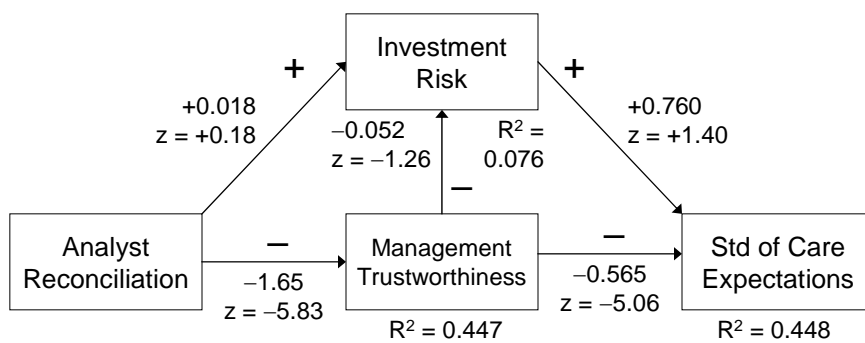


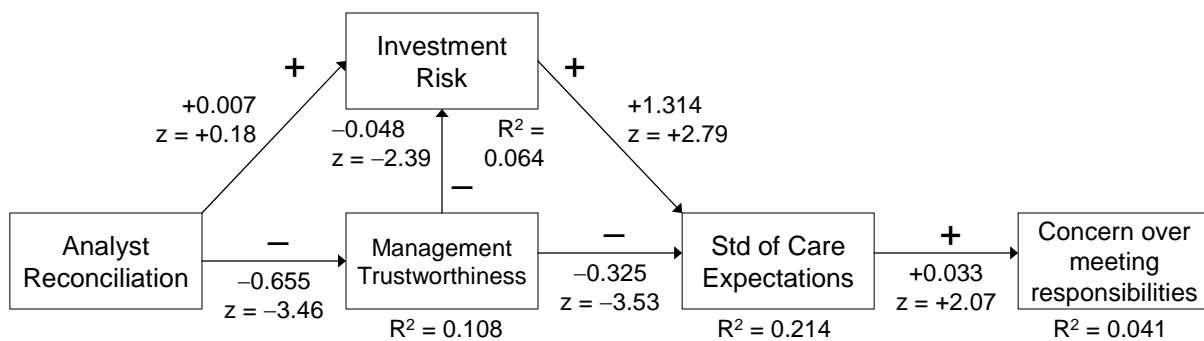
FIGURE 2
ANCOVA-adjusted means by condition. See Table 1 for definitions.



Panel A: Credibility and audit expectations measured on 11-pt Likert scales



Panel B: Trustworthiness and audit standard of care expectations measured using factor scores



Panel C: Extension of path based on additional data, with trustworthiness and audit standard of care expectations measured using factor scores

FIGURE 3

Summary of predicted and observed relationships in participants' revised assessments in the two source treatment conditions. See Table 1 for definitions. Plus signs (+) indicate expected positive relationships and minus signs (-) indicate expected negative relationships for participants who receive the reconciliation from an outside analyst relative to those who receive it from company management.

TABLE 1
Results

Panel A: Descriptive statistics: Mean (standard deviation)

<u>Reporting Condition^b</u>	<u>N</u>	<u>Management Credibility^a</u>			<u>Investment Risk^a</u>			<u>Audit Expectations^a</u>		
		<u>Initial</u>	<u>Revised</u>	<u>ANCOVA adjusted^c</u>	<u>Initial</u>	<u>Revised</u>	<u>ANCOVA adjusted^c</u>	<u>Initial</u>	<u>Revised</u>	<u>ANCOVA adjusted^c</u>
<i>Control conditions:</i>										
Disclosure	25	0.524 (0.183)	0.528 (0.193)	0.536	0.252 (0.240)	0.328 (0.259)	0.358	0.550 (0.146)	0.544 (0.163)	0.554
Recognition	27	0.515 (0.170)	0.503 (0.153)	0.515	0.674 (0.170)	0.670 (0.172)	0.585	0.594 (0.123)	0.593 (0.120)	0.581
<i>Experimental conditions:</i>										
Mgmt (Disclosure plus management-sourced reconciliation)	23	0.570 (0.194)	0.435 (0.217)	0.423	0.230 (0.290)	0.652 (0.301)	0.688	0.526 (0.098)	0.619 (0.178)	0.641
Analyst (Disclosure plus analyst-sourced reconciliation)	20	0.570 (0.184)	0.295 (0.193)	0.283	0.230 (0.258)	0.755 (0.182)	0.791	0.612 (0.126)	0.802 (0.094)	0.782

Panel B: Planned contrasts using adjusted means^c

<u>Contrast^b</u>	<u>Management Credibility^a</u>			<u>Investment Risk^a</u>			<u>Audit Expectations^a</u>		
	<u>Estimate (Std error)</u>	<u>t</u>	<u>p^d</u>	<u>Estimate (Std error)</u>	<u>t</u>	<u>p^d</u>	<u>Estimate (Std error)</u>	<u>t</u>	<u>p^d</u>
Reconciliation Source: Mgmt < Analyst	-0.140 (0.053)	-2.64	0.005	0.103 (0.069)	1.49	0.070	0.141 (0.041)	3.43	<0.001
Controls: Recognition < Disclosure	0.020 (0.048)	0.42	0.672	-0.226 (0.075)	-3.00	0.004	-0.027 (0.037)	-0.74	0.464
Recognition < Analyst	-0.232 (0.051)	-4.52	<0.001	0.207 (0.080)	2.59	0.011	0.201 (0.039)	5.21	<0.001
Recognition < Mgmt	-0.092 (0.049)	-1.86	0.066	0.104 (0.078)	1.34	0.185	0.060 (0.038)	1.60	0.114

a Each of the dependent measures (management credibility, investment risk, and audit expectations) are assessed on 11-point Likert scales labeled from 0 to 100, in 10-point increments, with higher values indicating higher levels of assessed credibility, risk, or expectations. For ease of interpretation, we divide by 100 and present all of our dependent measures on a percentage basis. Management credibility is participants' assessment of how credible (trustworthy or

believable) management is likely to be compared to the management of other companies in the industry. Investment risk is participants' assessment of how the risk of investing in the company's long-term debt compares to the industry in general. Participants assess two aspects of their expectations for the auditors: the level of audit risk that the company's auditors should apply compared to the typical audit with respect to (1) the overall audit, and (2) the leases held by the company; we report the mean as our measure of participants' audit expectations.

- b We manipulate the availability of financial disclosures for a company's leases in four between-subjects conditions. In the first two (control) conditions, the lease obligations are either disclosed or recognized. In the remaining two (treatment) conditions, participants receive a supplemental reconciliation indicating the company's financial results as if the disclosed lease obligations had instead been recognized. The source of the reconciliation is manipulated as either (1) company management or (2) an independent research analyst. In all conditions, the lease footnote provides identical information, sufficient for knowledgeable individuals to constructively capitalize the leases (or reverse the recognition, if they wish to do so).
- c Participants are asked to provide two sets of dependent measures. Initial responses are recorded after participants first view excerpts from the company's financial statements, including footnote disclosure of the company's lease information. Revised responses are recorded after participants review a duplicate of the initial financial information and (if applicable) the supplemental reconciliation. In our analyses, we adjust for the influence of participants' initial responses using analysis of covariance (ANCOVA) and thus, we report the ANCOVA least squares adjusted means.
- d Reported p-values are one-tailed for the reconciliation source contrasts and two-tailed for the control contrasts.