When assuming less responsibility backfires : the effects of audit responsibility assignment, audit failure location, and engagement partner signature on auditor legal liability

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**WHEN ASSUMING LESS RESPONSIBILITY
BACKFIRES: THE EFFECTS OF AUDIT
RESPONSIBILITY ASSIGNMENT, AUDIT FAILURE
LOCATION, AND ENGAGEMENT PARTNER
SIGNATURE ON AUDITOR LEGAL LIABILITY**

**TONGRUI CAO
NANYANG BUSINESS SCHOOL**

2020

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SIGNATURE ON AUDITOR LEGAL LIABILITY**

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A thesis submitted to the Nanyang Technological University
in partial fulfillment of the requirement for the degree of
Doctor of Philosophy

2020

Statement of Originality

I hereby certify that the work embodied in this thesis is the result of original research, is free of plagiarised materials, and has not been submitted for a higher degree to any other University or Institution.

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SUMMARY

This thesis examines the effects of audit responsibility assignment (divide versus assume), audit failure location (lead versus participating audit firm), and engagement partner signature (present versus absent) on jurors' evaluations of auditor legal liability. The PCAOB recently proposed two auditing standards amendments regarding how the lead audit firm assigns audit responsibility in group audits, and whether the engagement partner of the lead audit firm signs the group audit report in his/her personal name. This thesis finds that relative to assuming full audit responsibility for the entire audit engagement, dividing audit responsibility with the participating audit firm reduces the lead audit firm liability when the audit failure is found in the audit area of the participating audit firm. Dividing audit responsibility thus appears beneficial for the lead audit firm but actually comes with costs: it increases the lead audit firm liability when the audit failure is found in the audit area of the lead audit firm. Further, this thesis finds that an engagement partner signature generally reduces jurors' negligence verdicts because signing an audit report with the engagement partner's name increases jurors' assessments of auditor credibility.

Keywords: Group Audits, Audit Responsibility, Engagement Partner Signature, Jurors' Judgment and Decision-making

1. INTRODUCTION

The use of two or more audit firms in an audit engagement has gradually gained prevalence in the past two decades due to the increasing demand for specialized industry knowledge in current audits and the growing trend of multinational auditing (PCAOB 2016). To improve the transparency and reliability of the group audit reporting, the Public Company Accounting Oversight Board (PCAOB) recently proposed amendments to extant auditing standards that require the disclosure of how the lead audit firm assigns audit responsibility in a group audit.¹ According to the proposed amendment to auditing standards (PCAOB 2016), the lead audit firm can either assume full audit responsibility for the entire audit engagement or divide audit responsibility with participating audit firms.^{2,3} In this thesis, I examine how these two audit responsibility assignment approaches impact the lead audit firm's litigation risk.

Examining the litigation impact of audit responsibility assignment by the lead audit firm in a group audit is of interest to standard setters and regulators. Standard setters and regulators prescribe that the lead audit firm discloses the

¹ Group audits represent audits of consolidated financial statements. A group audit may require one or more participating audit firms auditing components of consolidated financial statements (AICPA 2013).

² For clarity, I use the following conventions. In this thesis, I refer to those participating in the audit other than the lead audit firm as "participating audit firms." In the PCAOB proposals or other academic studies, "participating audit firms" may be referred to as "participating auditors" or "other audit participants." "Lead audit firms" may be called "lead auditors," "principal auditors," or "principal audit firms." These terms can be used interchangeably.

³ Under PCAOB (2016), the lead audit firm is required to disclose in Form AP how it assigns audit responsibility within a group audit. Although it is common that the lead audit firm divides audit responsibility with participating audit firms (Mao et al. 2019), extant standards do not have a specific regulation that clearly indicates whether it is permissible for the lead audit firm to divide audit responsibility with participating audit firms. PCAOB (2016) proposes a more specific regulation that permits the lead audit firm to divide audit responsibility within a group audit.

identities of and work performed by participating audit firms involved in a group audit (PCAOB 2015b). The lead audit firm is responsible for expressing an audit opinion over the consolidated financial statements, though components of financial statements are audited by participating audit firms (AICPA 2013). The ambiguity in the responsibility of the lead audit firm and that of the participating audit firm impedes the establishment of effective coordination and efficient communication in the group audit. These challenges in the group audit potentially deteriorate the audit quality and increase the litigation risk of the lead audit firm (Dee, Lulseged, and Zhang 2015; Downey and Bedard 2019).⁴ Because of the inherent uncertainty and the heightened risk of audit failures in group audits, whether the approach in which the lead audit firm assigns audit responsibility influences the lead audit firm's litigation risk is an important question.

I also examine whether this effect is contingent on audit failure location; namely, whether the audit failure occurs in the audit area of the lead audit firm or that of the participating audit firm. Since auditing standards for group audits state that participating audit firms are responsible for ensuring their own audit quality (PCAOB 2004, 2010), the involvement of participating audit firms and the division of audit responsibility seem to constrain the lead audit firm's litigation risk. However, this may not occur. The proposed standard amendment requires the lead audit firm to maintain effective supervision on participating

⁴ Downey and Bedard (2019) study 147 group audit engagements. They conclude that coordination and communication challenges in the group audit increase the risk of group audit failures, and thus, the lead audit firm bears an elevated risk of reputation damage and litigation cost.

audit firms (PCAOB 2016).⁵ A poor supervision on the audit work performed by participating audit firms may increase the risk that the lead audit firm fails to recognize and correct audit failures caused by participating audit firms. At the same time, regulators acknowledge that it is not possible to attain perfect supervision on participating audit firms, especially when participating audit firms are geographically distant from the lead audit firm (PCAOB 2016). Additional supervisory procedures may impose undue burdens on audit resources owned by the lead audit firm, thereby potentially increasing the likelihood that audit failures occur in the audit area of the lead audit firm. Given that the lead audit firm signs the group audit report and expresses an audit opinion over the consolidated financial statements, an audit failure, whether it is caused by the lead audit firm or by the participating audit firm, will influence the lead audit firm's litigation risk.

Effective supervision on participating audit firms necessitates a sufficient input of audit resources (e.g., personnel and audit hours) by the lead audit firm. Nevertheless, the lead audit firm can choose to divide audit responsibility with participating audit firms and publicly claim that the audit opinion related to the audit area of participating audit firms is solely based on their audit reports

⁵ Extant standards allow the lead audit firm to limit its involvement in supervision. Under extant standards, supervisory procedures are unspecified, and the engagement partner of lead audit firm can determine the extent of supervision. The PCAOB (2016) imposes a more uniform approach that strengthens the lead audit firm's supervision of participating audit firms.

(PCAOB 2016).^{6, 7} Financial statement users are usually unaware of what procedures are performed by the lead audit firm, leading to uncertainty about the audit quality and risks associated with the use of participating audit firms. To mitigate such concerns about uncertainty in group audits, regulators require the lead audit firm to disclose the name of the engagement partner, as well as the name, location, and participation extent of participating audit firms (PCAOB 2015b, 2016). Such information is disclosed in Form AP, which is a separate form attached to the audit report. With respect to the group audit report, the standard amendment permits the engagement partner of the lead audit firm to sign the audit report in his/her personal name in addition to the name of the lead audit firm (PCAOB 2015b). The PCAOB believes that providing information about the engagement partner and participating audit firms will achieve objectives of enhanced transparency and accountability for the group audit (PCAOB 2009, 2015b).

In this thesis, I focus on the litigation impact of an engagement partner signature, a situation where the engagement partner signs the audit report in his/her personal name, in addition to the name of the audit firm, compared to the litigation impact of an audit firm signature, a situation where the engagement

⁶ Mao et al. (2019) identify 2226 group audits (client-years during the period of 2009-2018) where participating audit firms play a substantial role in auditing U.S. listed firms. There are only 85 cases where one audit firm audits all components. Mao et al. (2019) further find that, of the total 2311 client-years observations, 1695 client-years are group audits in which the lead audit firm assumes full audit responsibility for the entire audit engagement, and 616 client-years are group audits in which the lead audit firm divides audit responsibility with participating audit firms.

⁷ In 2018, American Airline Group Inc. was audited by Ernst & Young LLP, and US Airway Group Inc., a wholly-owned subsidiary of American Airline Group Inc., was audited by KPMG LLP. As the lead audit firm, Ernst & Young divided audit responsibility with KPMG and thus did not assume audit responsibility for US Airway Group Inc.

partner signs the audit report in the name of the audit firm only. Prior research suggests that requiring the engagement partner to sign the audit report in his/her personal name increases auditors' accountability and improves audit quality (Carcello and Li 2013; Burke, Hoitash, and Hoitash 2018). However, many commenters claim that engagement partner signature will give rise to unintended negative consequences, particularly with respect to auditors' litigation risk (PCAOB 2015b, 2016). Given the importance of assessing costs of regulatory changes, examining the litigation impact of the engagement partner signature is of interest to regulators and auditors.

The story model for juror decision-making suggests that jurors gather evidence and organize it with causal links to construct narrative stories when evaluating auditor negligence (Pennington and Hastie 1981, 1986). Central to the story construction is the evaluation of evidence, which includes two components: causal influence analysis and credibility assessment (Pennington and Hastie 1992). Based on the story model, I predict that audit responsibility assignment and audit failure location jointly influence jurors' assessments of auditor causal influence on the audit failure and auditor credibility, which in turn determine jurors' negligence verdicts. Specifically, when the audit failure occurs in the audit area of the lead audit firm, jurors will tend to perceive that the lead audit firm has strong causal influence on the audit failure, no matter how the lead audit firm assigns audit responsibility. However, I posit that dividing audit responsibility with the participating audit firm will have a negative effect on jurors' assessments of the lead audit firm's credibility. In group audits, assuming full audit

responsibility prompts jurors to perceive that the lead audit firm is competent and trustworthy in that it assumes full audit responsibility for the entire audit engagement. Therefore, jurors will perceive the lead audit firm to be less credible when the lead audit firm divides audit responsibility rather than assumes full audit responsibility. Overall, as low perceived auditor credibility increases jurors' negligence verdicts, the audit failure found in the audit area of the lead audit firm will induce higher negligence verdicts when the lead audit firm divides audit responsibility than when it assumes full audit responsibility.

When the audit failure occurs in the audit area of the participating audit firm, I predict that jurors will perceive the lead audit firm has weaker causal influence on the audit failure if the lead audit firm divides audit responsibility with the participating audit firm. Regarding jurors' credibility assessments, the audit failure caused by the participating audit firm induces lower blame attributions because the lead audit firm separates itself from the audit failure by dividing audit responsibility with the participating audit firm. The audit failure caused by the participating audit firm also provides ex-post justification for the choice made by the lead audit firm to divide audit responsibility with the participating audit firm, thereby reducing the negative effect of dividing audit responsibility on jurors' assessments of the lead audit firm's credibility. Overall, I predict that dividing audit responsibility with the participating audit firm reduces jurors' negligence verdicts related to the audit area of the participating audit firm.

I posit that a personal name signature on the audit report increases jurors' assessments of auditor credibility. Signing an audit report in the engagement

partner's name reflects self-mention by the engagement partner in the audit report. The self-mention in audit reports associates engagement partners with their audit opinions and emphasizes that engagement partners have strong confidence in the audit report (Asay, Libby, and Rennekamp 2018). Thus, an engagement partner signature increases jurors' assessments of auditor credibility. Given that dividing audit responsibility negatively impacts jurors' assessments of the lead audit firm's credibility when the audit failure is caused by the lead audit firm, an engagement partner signature that increases jurors' assessments of the lead audit firm's credibility will reduce their negligence verdicts. Such an effect is limited when the lead audit firm assumes full audit responsibility or when the audit failure is caused by the participating audit firm because jurors perceive the lead audit firm credible in such cases.

To test my predictions, I conduct a $2 \times 2 \times 2$ between-subjects experiment with 300 Amazon Mechanical Turk (AMT) workers as participants. I manipulate audit responsibility assignment by having the lead audit firm divide audit responsibility with the participating audit firm or assume full audit responsibility for the entire audit engagement. I manipulate audit failure location in terms of whether a severe audit failure occurs in an audit conducted by either the lead audit firm or the participating audit firm. Participants are randomly assigned to one of two signature conditions, in which the engagement partner of the lead audit firm signs the group audit report either in the name of the lead audit firm only or in the engagement partner's name additionally. Participants assume the role of jurors to assess a negligence verdict, evaluate lead audit firm negligence

on a continuous scale, and determine the damage compensations in a lawsuit against the lead audit firm.

Consistent with my predictions, I find that relative to assuming full audit responsibility, dividing audit responsibility prompts jurors' negligence verdicts against the lead audit firm to be higher (lower) when the audit failure is found in the audit area of the lead audit firm (participating audit firm). My process model analysis shows that the effects of audit responsibility assignment on jurors' negligence verdicts are mediated by jurors' assessments of the lead audit firm's causal influence on the audit failure and jurors' assessments of the lead audit firm's credibility. I also find that jurors' negligence verdicts are not influenced by audit failure location when the lead audit firm assumes full audit responsibility for the entire audit engagement. This implies that auditors' litigation risk increases when they assume full audit responsibility because jurors are inclined to think that the audit failure caused by the participating audit firm is the responsibility of the lead audit firm.

I further find that an engagement partner signature reduces jurors' negligence verdicts. My mediation analysis shows that an engagement partner signature has no impact on jurors' assessments of auditor causal influence on the audit failure, but that it significantly improves jurors' assessments of auditor credibility, which ultimately reduces jurors' negligence verdicts. These findings corroborate the story model for juror decision-making (Pennington and Hastie 1981), which emphasizes the importance of credibility assessments in influencing jurors' evaluations of evidence and auditor negligence.

This thesis makes a few contributions. It provides experimental evidence on how the approach in which the lead audit firm assigns audit responsibility in group audits affects the lead audit firm's litigation risk. Specifically, I find that dividing audit responsibility constrains the lead audit firm's responsibility scope, but has a potential downside in that it increases its litigation risk when the audit failure is caused by the lead audit firm. I do not make prescriptive accounting policy recommendations, but my results suggest that the lead audit firm indeed faces a risky trade-off relating to the approach in which the lead audit firm assigns audit responsibility in group audits. This thesis identifies the underlying reasons for this phenomenon. I propose and test a theoretical model of how audit responsibility assignment influences jurors' negligence verdicts. I find that divided audit responsibility reduces jurors' assessments of auditor causal influence on the audit failure caused by the participating audit firm, but damages jurors' assessments of auditor credibility.

By examining the litigation impact of two audit responsibility assignment approaches in group audits, this thesis reveals potential litigation costs of the lead audit firm supervising the audit work performed by participating audit firms. The lead audit firm needs to certify the audit work performed by participating audit firms if it assumes full audit responsibility for the entire audit engagement. In this case, it is necessary for the lead audit firm to maintain effective supervision on participating audit firms, which facilitates the lead audit firm in identifying and remediating audit failures caused by participating audit firms. However, the proposed amendment (PCAOB 2016) requires the lead audit firm to maintain a

high level of supervision on participating audit firms even if the lead audit firm divides audit responsibility with participating audit firms. A high level of supervision in group audits may require excessive consumptions of audit resources owned by the lead audit firm (PCAOB 2016), which may then trigger an audit failure in its own audit work. My experimental results suggest that an audit failure caused by the lead audit firm significantly increases the lead audit firm's litigation risk if the lead audit firm divides audit responsibility. In this case, a high level of supervision on participating audit firms may expose the lead audit firm to increased litigation risk. These findings are of interest to auditors and regulators to assign audit responsibility among audit participants and determine the appropriate level of supervision in group audits (PCAOB 2016, 2017).

This thesis complements archival research that examines the implications of an engagement partner signature on the audit report (Carcello and Li 2013; Knechel, Vanstraelen, and Zerni 2015; Lee and Levine 2016; Burke, Hoitash, and Hoitash 2018). My results suggest that an engagement partner signature reduces jurors' negligence verdicts. The reduction in audit firms' litigation risk arises from the increase in jurors' assessments of auditor credibility. These findings alleviate auditors' concerns that an engagement partner signature increases their litigation risk, and answer the call for more research on the potential effects of engagement partner identification (PCAOB 2015b, 2016, 2017; Cunningham, Li, Stein, and Wright 2019).

The rest of the paper is organized as follows. Section II contains background and hypotheses development. Section III provides details of the experiment, and

Section IV discusses the experimental results. Section V includes a summary and a discussion of this thesis's implications and limitations.

2. BACKGROUND AND HYPOTHESES DEVELOPMENT

2.1 Group Audits

In many public company audits, the lead audit firm issues the audit report, but important audit work is often performed by other independent accounting firms (i.e., participating audit firms). The benefits of involving participating audit firms in an audit engagement are twofold. First, audit firms vary with respect to industry specialization and the quality of services they provide to their clients. The involvement of participating audit firms specializing in certain industries compensates for any deficiency in the lead audit firm's specialized industry knowledge (AICPA 2013; PCAOB 2004). Second, many large companies have multiple locations and international operations. The audit of one such company may include auditing financial statements of one or more subsidiaries, divisions, branches, and components. In auditing such companies, the lead audit firm relies on the work performed by participating audit firms (PCAOB 2016; Downey and Bedard 2019). Group audits refer to audits of consolidated financial statements, which involve one lead audit firm and may involve one or more participating audit firms (AICPA 2013).⁸

Due to the inherent complexity of audits that involve participating audit firms, group audits entail increased ambiguity in the division of audit

⁸ Dee et al. (2015) identify 149 issuers that have participating auditors in their audits. Out of the 149 issuers, 138 issuers have only one participating audit firm, 10 issuers have two participating audit firms, and one issuer has three participating audit firms.

responsibility. The PCAOB proposed amendments to its standards to improve the transparency of group audits. In April 2016, the PCAOB issued new guidance requiring the lead audit firm to disclose the identity of and audit work performed by participating audit firms in Form AP attached to the audit report. In the audit report and Form AP, the lead audit firm discloses whether it assumes full audit responsibility for the entire audit engagement or divides audit responsibility with participating audit firms (PCAOB 2016).

As another endeavor to improve the transparency of group audits, the PCAOB recently adopted Rule 3211 that requires the lead audit firm to disclose the name of the engagement partner in Form AP. Besides the disclosure of his/her personal name in Form AP, the engagement partner of the lead audit firm has the discretion to sign the group audit report in the name of the lead audit firm only or his/her personal name additionally (PCAOB 2015b). In this thesis, I use “audit firm signature” to refer to when the engagement partner signs the audit report in the name of the audit firm only, and “engagement partner signature” to refer to when the engagement partner signs the audit report in both his/her personal name and the name of the lead audit firm.

2.2 Litigation Risk of the Lead Audit Firm and the Story Model for Juror Decision-making

In group audits, the lead audit firm issues the group audit report and expresses an audit opinion over the consolidated financial statements. It is necessary for the lead audit firm to maintain effective supervision over the audit work performed by participating audit firms (PCAOB 2016). Ineffective

supervision over participating audit firms may cause audit failures related to the audit area of participating audit firms. However, if the lead audit firm expends excessive audit resources on the supervision on participating audit firms, it will have insufficient audit resources to perform other work on the same audit engagement (PCAOB 2016). This may potentially increase the likelihood that the lead audit firm fails to detect material misstatements in the portion of financial statements audited by the lead audit firm. The lead audit firm is exposed to litigation risk when an audit failure occurs, whether this audit failure is caused by the lead audit firm or by participating audit firms.

To evaluate auditor negligence, jurors actively construct a narrative story, and the process of story construction rests on evidence and explanations provided by the lead audit firm (Pennington and Hastie 1981). The story model for juror decision-making suggests that evidence evaluation entails two dimensions (Pennington and Hastie 1986). The first dimension is *causal influence analysis*, in which jurors connect evidence in causal relationships and evaluate whether auditors have causal influence on the audit failure. With causal influence analysis, jurors construct a causal model to explain the available facts and base their verdict decisions on the causal explanations they have formed using the available evidence (Pennington and Hastie 1992). If the evidence suggests a clear causal relationship between auditors and audit failures, jurors will find auditors negligent in the performance of the audit (Alicke 2000; Backof 2015; Gimbar, Hansen, and Ozlanski 2016).

The second dimension is *credibility assessment*, in which jurors assess the credibility of evidence or the credibility of auditors who provide such evidence. Given that auditors are the source of evidence, the plausibility of the evidence hinges on how the jurors perceive the auditor credibility. Therefore, auditor credibility is vital to jurors' evaluations of auditor negligence. Auditor credibility refers to the extent that auditors are competent and trustworthy (Giffin 1967; Mercer 2005). Prior accounting studies show that perceived auditor independence, technical competence and knowledge, a failure to deliver a high-quality audit, and perceived audit usefulness are determinants of perceived auditor credibility (Shockley 1981; Messier, Owhoso, and Rakovski 2008; Han, Jamal, and Tan 2011; Skinner and Srinivasan 2012; Funnell, Wade, and Jupe 2016). According to the story model, credibility assessment can provide valuable insights for jurors in determining the acceptability of a story, and the resulting level of confidence in that story. As jurors' evaluations of auditor credibility decrease, the influence of evidence in favor of auditors decreases and jurors are more likely to return unfavorable negligence verdicts against the auditors.

In the discussion below, I discuss how auditor responsibility assignment and audit failure location jointly influence jurors' negligence verdicts via these two mechanisms—causal influence analysis and auditor credibility assessment.

2.3 The Effects of Audit Responsibility Assignment and Audit Failure Location

In group audits, the lead audit firm can choose to divide audit responsibility with participating audit firms in proportion to their relative participation in the

audit engagement. The other option for the lead audit firm is to assume full audit responsibility for the entire audit engagement. I posit that the effects of audit responsibility assignment on jurors' assessments of auditor causal influence and auditor credibility are contingent on the audit failure location. I define the audit failure location as the audit area where the audit failure is found, and classify the audit failure location into two categories: the audit area of the lead audit firm, and the audit area of the participating audit firm.

Next, I discuss how dividing audit responsibility with participating audit firm, compared to assuming full audit responsibility for the entire audit engagement, impacts jurors' causal influence analysis and credibility assessments, and how such effects are moderated by audit failure location and ultimately determine jurors' negligence verdicts. I posit that jurors' assessments of causal influence of the lead audit firm on its own audit area are not influenced by audit responsibility assignment. Specifically, when the audit failure occurs in the audit area of the lead audit firm, jurors will tend to perceive that the lead audit firm has strong causal influence on the audit failure, no matter how the lead audit firm assigns audit responsibility. Even if the lead audit firm divides audit responsibility with the participating audit firm, it still needs to take responsibility for its own audit area. More importantly, the assignment of responsibility relates to an area outside the lead auditor's audit area, so it is difficult to conceive how the participating audit firm can be causally responsible for problems in the lead auditor's audit area. Causal influence analysis suggests that the approach in which the lead audit firm assigns audit responsibility has no effect on jurors'

assessments of the lead audit firm negligence when the audit failure is caused by the lead audit firm.

However, the approach in which the lead audit firm assigns audit responsibility impacts jurors' assessments of auditor credibility and thus influences jurors' negligence verdicts. Social psychology research discusses how responsibility assignment affects credibility. Goffman (1971) suggests that taking responsibility shows a person's integrity, trustworthiness, and reliability. In this vein, prior studies suggest that taking responsibility alleviates negative outcomes of crimes (Snyder and Higgins 1988; Waddock, Bodwell, and Graves 2002; Chen and Loftus 2019). An auditor's responsibility is to plan and perform the audit to obtain reasonable assurance regarding whether the financial statements are free of material misstatements, and whether misstatements are caused by errors or frauds (Kadous 2000; PCAOB 2005). A failure to fully carry out audit responsibility inflicts damages on auditors' credibility as professional gate-keepers of financial statements (Alles, Kogan, and Vasarhelyi 2004). In group audits, although the lead audit firm has the discretion to divide audit responsibility, assuming audit responsibility still prompts jurors to perceive that the lead audit firm is competent and trustworthy in that it assumes full audit responsibility and assures the entire audit engagement.

The PCAOB (2016) stipulates that the lead audit firm conduct adequate supervision and proper evaluation of the work performed by the participating audit firm, no matter how the lead audit firm assigns audit responsibility. Since both audit responsibility assignment approaches can be seen to impose the same

level of supervision and evaluation on the participating audit firm (PCAOB 2016), the division of audit responsibility by the lead audit firm may lead to the perception that the lead audit firm intends to shirk or constrain its responsibility and reduce its litigation risk. Therefore, jurors will perceive the lead audit firm as less credible when the lead audit firm divides audit responsibility rather than assumes full audit responsibility. The low perceived auditor credibility negatively impacts the plausibility of evidence and explanations provided by the lead audit firm. Therefore, jurors likely accept a story in which the lead audit firm is negligent in the performance of the audit.

H1: Relative to assuming full audit responsibility, dividing audit responsibility will prompt jurors' evaluations of the lead audit firm negligence to be higher when the audit failure is found in the audit work performed by the lead audit firm.

Audit responsibility assignment impacts jurors' assessments of the lead audit firm's causal influence on the audit area of the participating audit firm. Jurors will perceive that the lead audit firm has weaker causal influence on the audit area of the participating audit firm when the lead audit firm divides audit responsibility, compared to when it assumes full audit responsibility. This is because the lead audit firm does not directly audit this area and publicly claims that its audit opinion of this area is solely based on the audit opinion issued by the participating audit firm. By dividing audit responsibility with the participating audit firm, the lead audit firm reduces its causal influence on the audit failure caused by the participating audit firm. Given a lack of evidence suggesting a clear

causal link between the lead audit firm and the audit failure caused by the participating audit firm, jurors will accept the story in which the lead audit firm is innocent in the performance of the audit.

As I discussed in the development of H1, dividing audit responsibility with the participating audit firm has a negative effect on jurors' assessments of the lead audit firm's credibility. However, with the benefit of hindsight, the audit failure caused by the participating audit firm suggests that the decision made by the lead audit firm to divide audit responsibility with the participating audit firm is a wise one. The lead audit firm is perceived to be competent when it separates itself from a problematic audit, and to be trustworthy when it publicly discloses the scope of its audit responsibility. Thus, the audit failure caused by the participating audit firm mitigates the negative effect of dividing audit responsibility on jurors' assessments of the lead audit firm's credibility. Given such reduced negative effect on jurors' credibility assessments and the lower causal influence perceived by jurors on the audit failure, dividing audit responsibility with the participating audit firm reduces jurors' negligence verdicts when the audit failure is caused by the participating audit firm.

H2: Relative to assuming full audit responsibility, dividing audit responsibility will prompt jurors' evaluations of the lead audit firm negligence to be lower when the audit failure is found in the audit work performed by the participating audit firm.

Figure 1 shows the theoretical model of how audit responsibility assignment impacts jurors' negligence verdicts through its effect on jurors' assessments of auditor causal influence on audit failure and auditor credibility.

[Insert Figure 1 Here]

2.4 The Effect of Engagement Partner Signature

As per the amendment proposed in PCAOB (2015b), the engagement partner of the lead audit firm can choose to sign the group audit report in his/her personal name, on top of the current requirement for the audit firm's name to appear in the form of a signature. Though a signature of the audit firm's name on the audit report is required in audit practice (PCAOB 2009), an additional signature of personal name on the audit report is advocated by the PCAOB as a means of improving auditor accountability (Carcello and Li 2013; PCAOB 2015b). In this thesis, I examine the effect of an engagement partner signature, incremental to that of the audit firm signature, on jurors' negligence verdicts.

Auditors have a statutory duty to certify that their clients' financial statements are free of material misstatements. They are subject to internal-firm quality inspections, PCAOB inspections, and SEC enforcement actions (Carcello and Li 2013). Bearing this in mind, jurors perceive auditors as having strong causal influence on the audit, regardless of audit report signatures. Moreover, an audit firm signature is required and commonly seen in audit practice (PCAOB 2015a, 2015b). Given the strong accountability requirements on auditors absent an individual engagement partner signature, causal influence analysis suggests

that an engagement partner signature on the audit report has a trivial incremental impact on jurors' assessments of auditor causal influence over the audit failure.

An engagement partner's signature in the audit report is an example of self-mention. Prior communication research argues that self-mention is a rhetorical device that reflects the authors' stance about their statements (Hyland 2001). Specifically, self-mention emphasizes that authors believe what they are saying. In a setting where a firm reports bad news, Chen and Loftus (2019) find that managers' self-mention using first-person singular pronouns (versus plural pronouns) in firm disclosures increases investors' perceptions of managers' credibility, presumably because investors believe that the managers with self-mention in a bad news situation are not shirking away from a bad situation.⁹ Following this literature, I posit that an engagement partner signature on the audit report can play a similar role—increasing jurors' assessments of auditor credibility by signaling that the auditor actively participates in the preparation of the audit report. High perceived auditor credibility due to an engagement partner signature prompts jurors to reduce their negligence verdicts when an adverse event occurs (Pennington and Hastie 1992). The credibility assessment in the story model suggests that an engagement partner signature on the audit report ameliorates jurors' judgments of auditor negligence when there is an audit failure.

⁹ Asay et al. (2018) also find that the use of first-person pronouns (versus the use of the company) in shareholder letters increases investors' assessments of disclosure credibility and management credibility (see their experiment 4), but this effect is absent when first-person pronouns are used in only the final sentence of the letter (rather than throughout the letter) or when the shareholder letter contains a CEO photo (see their experiments 1-3).

As discussed previously, dividing audit responsibility reduces jurors' assessments of auditor credibility, and the low perceived auditor credibility increases the lead audit firm negligence when the audit failure is caused by the lead audit firm. The presence of an engagement partner signature is associated with an increase in jurors' evaluations of auditor credibility. The story model suggests that high perceived auditor credibility reduces jurors' negligence verdicts. Thus, I predict that an engagement partner signature will reduce jurors' evaluations of the lead audit firm negligence when the lead audit firm divides audit responsibility and the audit failure is caused by the lead audit firm.

H3: Relative to the audit firm signature, an engagement partner signature will reduce jurors' evaluations of the lead audit firm negligence when the lead audit firm divides audit responsibility and the audit failure is found in the audit work performed by the lead audit firm.

Such an effect may not persist when the lead audit firm assumes full audit responsibility for the entire audit engagement. As I discussed in the development of H1, jurors perceive the lead audit firm to be credible when the lead audit firm assumes full audit responsibility. Since jurors have perceived high auditor credibility, an engagement partner signature may have a weaker or even null incremental effect on jurors' assessments of auditor credibility and auditor negligence. Similarly, the effect of an engagement partner signature on jurors' negligence verdicts is likely small when the lead audit firm divides audit responsibility and the audit failure is caused by the participating audit firm. This is because dividing audit responsibility separates the lead audit firm from the

audit failure caused by the participating audit firm. In this case, jurors will perceive the lead audit firm to be relatively free from blame, and thus an engagement partner signature may have a limited incremental influence on jurors' credibility assessments and negligence verdicts.

H4: Relative to the audit firm signature, an engagement partner signature will have no significant effect on jurors' evaluations of the lead audit firm negligence when the lead audit firm assumes full audit responsibility for the entire audit engagement, or when the lead audit firm divides audit responsibility and the audit failure is found in the audit work performed by the participating audit firm.

3. EXPERIMENT

I employed a $2 \times 2 \times 2$ between-participants design, with audit responsibility assignment (divide or assume audit responsibility), audit failure location (lead audit firm's or participating audit firm's audit failure), and engagement partner signature (present or absent) as independent variables. Experimental materials informed jury-eligible participants of an audit case that involved an audit failure and asked them to evaluate whether auditors behaved negligently in this audit case.

3.1 Participants

Three hundred participants were recruited from Amazon's Mechanical Turk (AMT), an online labor market that offers compensation for "workers" to

complete tasks.¹⁰ AMT has a diverse subject pool, with a variety of backgrounds, ages, ethnicity, and social and economic status, thereby being an optimal source of lay jurors (Mason and Suri 2012). Prior accounting research has used AMT participants to proxy for jurors (Brasel, Doxey, Grenier, and Reffett 2016; Maksymov and Nelson 2017; Brown, Majors, and Peecher 2015). Participants' lack of prior knowledge of relevant auditing standards puts them on a comparable position with lay jurors in a real auditor negligence trial.

Consistent with Brasel et al. (2016), I preset questions to screen out ineligible participants. Eligible participants must (1) be U.S. citizens above 18 years old; (2) never served on a jury regarding a financial crime; (3) never worked as an auditor, accountant, or lawyer; (4) never worked for any lending institutions (e.g., bank), mining/gravel companies, or the Environmental Protection Agency. To facilitate comprehension, I asked participants to answer some review questions and told them that only those who correctly answer 90 percent of review questions could earn \$4.00.¹¹

3.2 Experimental Tasks

Experimental instruments were adapted from Reffett (2010) and Brasel et al. (2016). Experimental materials instructed participants to assume the role of a juror in a real auditor negligence case. Participants completed experimental tasks online, which I programmed using Qualtrics. Participants began with some

¹⁰ Approval to use human participants in this experiment has been granted by the Institutional Review Board.

¹¹ Of 300 participants, 15 (5 percent) failed to correctly answer at least 90 percent of the comprehension check questions and were not compensated. Inferences from my results are unaffected when these responses are excluded.

pertinent background information about the financial statement preparation, the audit process, and the consequences of audit failures. Then participants read a case about an audit of a fictitious mining company (Main Inc.) with a subsidiary (Sub Inc.). The lead audit firm (M LLP) audited the holding company Main Inc. and signed the audit report of Main Inc.'s consolidated financial statements, while the participating audit firm (S LLP) audited Sub Inc. and signed the audit report of Sub Inc.'s financial statements.¹²

The primary issue related to the intentional understatement of an environmental restoration liability by the company's management. The company had several inactive quarries that needed to be restored to an environmental-friendly condition. The company recognized an environmental restoration liability with the assumption that all quarries can be filled up with water to create a lake, which is called the "lake method." However, some inactive quarries were found with hazardous materials, so the Environmental Protection Agency did not allow the company to use the lake method. In this case, the company had to fill the quarry with sandy soil and plant grass and trees, which was significantly more expensive than the lake method. The audit firm confirmed that restoring quarries using the lake method was appropriate and thus failed to detect the financial fraud. Bierhoff Inc., a lender who had lost a huge amount of money (\$9 million)

¹² In the experiment, I informed participants that M LLP maintained a moderate level of supervision on S LLP. To control the impact of supervision on participants' judgments, I held the supervision constant as moderate across experimental conditions. The reason why in the experiment I used a moderate level of supervision, instead of a high or a low level of supervision, is because a moderate level of supervision best reflects the reality in current audit practice (PCAOB 2016).

allegedly due to reliance on the financial statements and the group audit report issued by the lead audit firm, sued the lead audit firm M LLP for its negligence and asked for damages compensations.

Participants read a transcript of the lawsuit, including opening and closing arguments from the plaintiff and defense attorneys, oral testimonies of both the plaintiff and the defendant, and the expert testimony. Participants were also informed on how the lead audit firm assigned audit responsibility and who audited the part that incurred the audit failure. All participants were exposed to the audit firm signature. Half of them were additionally exposed to the engagement partner signature, and the other half were not.¹³ After reading all this information, participants were asked to determine whether the audit firm was negligent in the audit case and how much damages should be paid by the audit firm.

3.3 Manipulations

Audit Responsibility Assignment Manipulation. In the experiment, the lead audit firm (M LLP) either *divides* or *assumes* audit responsibility for the participating audit firm (S LLP). In the condition of *divide audit responsibility*, participants read the following information from the audit report:

We did not audit the financial statements of Sub Inc., a wholly owned subsidiary, whose financial statements reflect total assets constituting 10 percent of consolidated assets as of December 31, 2015, and total revenues constituting 12 percent of consolidated revenues for the year ended December 31, 2015.

¹³ Participants in both conditions were exposed to the name of the engagement partner. The name of the engagement partner was disclosed as part of the case background information. Providing this information to all participants meets the engagement partner disclosure requirement and allows me to test the engagement partner signature effect incremental to engagement partner disclosure.

Those financial statements were audited by S LLP whose report has been furnished to us, and our opinions, insofar as they relate to the amounts included for Sub Inc., are based solely on the report of S LLP.

The above paragraph was present if the lead audit firm (M LLP) divided audit responsibility with the participating audit firm (S LLP) but absent if the lead audit firm (M LLP) assumed audit responsibility for the entire audit engagement. The PCAOB provides that the lead audit firm, in its audit report, should make reference to audits of participating audit firms and clearly indicate the responsibility assignment between itself and participating audit firms when dividing audit responsibility with participating audit firms. However, when the lead audit firm decides to assume audit responsibility for participating audit firms, the lead audit firm should not make reference to audits of participating audit firms in the group audit report (PCAOB 2016). Consequently, the lead audit firm can fully disclose to the public its division of audit responsibility within a separate paragraph of the audit report, but this additional paragraph is absent when the lead audit firm assumes audit responsibility.¹⁴

Audit Failure Location Manipulation. The audit failure is caused by the lead audit firm or by the participating audit firm. In my experiment, the audit client Main Inc. had a subsidiary Sub Inc. Main Inc. was audited by the lead audit firm (M LLP), and Sub Inc. was audited by the participating audit firm (S LLP). I

¹⁴ PCAOB AS1205 and AS1206 provide that if the lead auditor decides to assume responsibility for the work of the other auditor insofar as that work relates to the lead auditor's expression of an opinion on the financial statements taken as a whole, no reference should be made to the other auditor's work or report. This stipulation arises from some concerns that including information in the auditor's report about other participants in the audit might confuse financial statement users as to who has overall responsibility for the audit, or appear to dilute the responsibility of the firm signing the auditor's report (PCAOB, 2015b).

manipulated audit failure location by informing participants that either Main Inc.'s management or Sub Inc.'s management understated the value of environmental restoration liability.

Engagement Partner Signature Manipulation. Under current auditing standards, the engagement partner of the lead audit firm has the discretion to sign the audit report either in his name (Michael Jones), in addition to the name of the audit firm, or in the audit firm's name (M LLP) only. It is considered to be an *engagement partner signature* if the engagement partner signed the audit report in his name Michael Jones, followed by the audit firm's name M LLP. It is considered to be an *audit firm signature* if the engagement partner signed the audit report in the audit firm's name M LLP only (See Appendix).

3.4 Dependent Variables

The primary dependent variables are negligence verdicts, evaluations of negligence on a continuous scale, and damages assessments. Specifically, I asked participants to indicate whether they found M LLP negligent in the performance of Main Inc.'s audit (0 = Not negligent, 1 = Negligent). I also asked participants to rate the likelihood that M LLP was negligent in the performance of Main Inc.'s audit (0 = Certainly not negligent, 100 = Certainly negligent). To assess damages, participants were asked to determine the amount of damages compensation they would require M LLP to pay to the plaintiff, Bieroff Inc. Participants chose on a scale an amount between 0 and \$9 million, with increments of \$0.1 million.

4. RESULTS

4.1 Manipulation Checks

To ensure that participants attended to my manipulations, I asked participants three questions related to the case. The first question asked participants to indicate how the lead audit firm assigned audit responsibility. Participants responded to this question by choosing either “the lead audit firm divides audit responsibility” or “the lead audit firm assumes full audit responsibility.” Ninety-one percent (274 out of 300) of participants answered this question correctly. The second question asked participants to indicate which audit firm, the lead or participating audit firm, audited the financial statements that incurred the audit failure. Ninety-two percent (278 out of 300) of participants answered the second question correctly. The third question asked about whether the engagement partner signed the audit report in his personal name. Ninety-six percent (289 out of 300) of participants answered the third question correctly. These high pass rates suggest successful manipulations. Eliminating participants who missed at least one manipulation check question does not change my primary findings. My analyses include all participants.

4.2 Test of Hypotheses

Table 1 presents jurors’ assessed verdicts against the lead audit firm. Table 1, Panel A presents the number and proportions of participants returning negligence verdicts against the lead audit firm. Table 1, Panel B presents the generalized linear model analysis. Table 1, Panel C presents comparison tests for the effects of audit responsibility assignment. Table 1, Panel D presents comparison tests for the effects of engagement partner signature.

[Insert Table 1 Here]

H1 predicts that dividing audit responsibility increases jurors' negligence verdicts when the audit failure location is the lead audit firm. Results in Table 1, Panel A and Table 1, Panel C show that dividing audit responsibility significantly increases jurors' negligence verdicts when the audit failure is caused by the lead audit firm (81.6 percent vs. 44.4 percent, $\chi^2 = 11.000$, $df = 1$, $p = 0.001$, one-tailed equivalent).¹⁵ H2 predicts that dividing audit responsibility reduces jurors' negligence verdicts when the audit failure is caused by the participating audit firm. Results show that dividing audit responsibility significantly reduces the incidence of negligence verdicts when the audit failure location is the participating audit firm (22.2 percent vs. 45.0 percent, $\chi^2 = 4.368$, $df = 1$, $p = 0.019$, one-tailed equivalent). These findings support H1 and H2.

I also find that jurors' negligence verdicts of the lead audit firm do not vary with audit failure location when the lead audit firm assumes full audit responsibility for the entire audit engagement. In Table 1, Panel A, when the lead audit firm assumes full audit responsibility, the rate of negligence verdicts is 44.4 percent for the audit failure caused by the lead audit firm (M LLP) and 45.0 percent for the audit failure caused by the participating audit firm (S LLP). The difference between the two groups is not significant ($\chi^2 = 0.002$, $df = 1$, $p = 0.961$, untabulated).

¹⁵ All reported p-values are two-tailed unless specified otherwise. One-tailed p-values are used to test directional predictions.

In sum, H1 and H2 collectively predict an interaction effect of audit responsibility assignment and audit failure location. Results are consistent with this hypothesized interaction ($\chi^2 = 23.746$, $df = 1$, $p < 0.001$). Specifically, I find that relative to assuming full audit responsibility, dividing audit responsibility prompts jurors' evaluations of auditor negligence to be higher (lower) when the audit failure location is the lead audit firm (the participating audit firm). This interaction effect is robust to both audit firm signature and engagement partner signature (see Table 1, Panel B). In Table 1, Panel B, I can see that the interaction effect of audit responsibility assignment and audit failure location is significant, but there is no three-way interaction. Figure 2 displays the pattern of results for jurors' negligence verdicts.

[Insert Figure 2 Here]

H3 predicts that an engagement partner signature reduces jurors' negligence verdicts when the lead audit firm divides audit responsibility and the audit failure is caused by the lead audit firm. Table 1, Panel A and Panel D show that, relative to the audit firm signature, an engagement partner signature significantly reduces the rate of negligence verdicts by 26.0 percent when the lead audit firm divides audit responsibility and the audit failure location is the lead audit firm (81.6 percent vs. 55.5 percent, $\chi^2 = 10.927$, $df = 1$, $p = 0.003$, one-tailed equivalent). This finding is consistent with H3. H4 predicts that an engagement partner signature has no effect on jurors' negligence verdicts when the lead audit firm assumes full audit responsibility for the entire audit engagement, or when the lead audit firm divides audit responsibility and the audit failure is caused by the

participating audit firm. However, comparison tests in Table 1, Panel D suggest that, regardless of audit responsibility assignment and audit failure location, an engagement partner signature significantly reduces jurors' negligence verdicts (all $p < 0.042$, one-tailed equivalents). This finding is inconsistent with H4. The generalized linear model analysis in Table 1, Panel B also shows that engagement partner signature has a significant main effect on jurors' negligence verdicts ($\chi^2 = 14.176$, $df = 1$, $p < 0.001$). These findings suggest that an engagement partner signature generally reduces jurors' evaluations of the lead audit firm negligence, no matter how the lead audit firm assigns audit responsibility in the group audit and where the audit failure occurs.

4.3 Alternative Dependent Measures

To assess the robustness of my results, I examine my hypotheses using alternative dependent variables - continuous negligence evaluations in Table 2 and damage assessments in Table 3. Inferences are unchanged if I use these two dependent variables.

[Insert Table 2 and Table 3 Here]

4.4 Supplemental Analyses

Path Analysis: Testing the Theoretical Model of Audit Responsibility Assignment Effect on Jurors' Negligence Verdicts

Figure 1 shows the theorized model of how audit responsibility assignment and audit failure location jointly affect jurors' negligence verdicts. My theory predicts that audit responsibility assignment influences jurors' assessments of auditor causal influence on the audit failure (link 1) and auditor credibility (link

2 and 4), and ultimately determines their negligence verdicts (link 3 and 5). To measure jurors' assessments of auditor causal influence on the audit failure (*Causal Influence*), I asked participants to evaluate whether the lead audit firm caused the audit failure (0 = Not at all the cause, 100 = Completely the cause) and whether the alleged misstatement is foreseeable to the lead audit firm prior to issuing an unqualified opinion (0 = Not at all foreseeable, 100 = Completely foreseeable).¹⁶ These two questions are highly related (Pearson correlation = 0.815, $p < 0.044$, Cronbach's alpha = 0.911, untabulated). I perform a principal component analysis and obtain one latent factor that accounts for the majority of the variance (eigenvalue = 1.801, variance explained = 90.60 percent, untabulated). I use the average of these two responses to proxy for the variable of my interest, *Causal Influence*. Table 4 reports the results of jurors' assessments of causal influence. To measure jurors' assessments of auditor credibility, I asked participants to assess the competence (0 = Not at all competent, 100 = Very competent) and trustworthiness (0 = Not at all trustworthy, 100 = Very trustworthy) of the lead audit firm. These two questions are highly related (Pearson correlation = 0.960, $p < 0.001$, Cronbach's alpha = 0.983, untabulated). I perform a principal component analysis, which reveals a single latent factor (eigenvalue = 1.960, variance explained = 97.98 percent, untabulated). I use the

¹⁶ Following Backof (2015), I also asked participants to evaluate whether the lead audit firm intends to perform a good audit (0 = Not at all intended, 100 = Completely intended). My results suggest that audit responsibility assignment does not significantly influence participants' assessment of auditors' intention to conduct a good audit (79.47 and 81.31 for dividing and assuming audit responsibility respectively, $p = 0.27$). This finding is consistent with Gimbar et al. (2016), who find that perceived control equates to the sum of perceived causation and foreseeability.

average of the two responses as my measure of Perceived Auditor Credibility. Table 5 reports the results of jurors' assessments of auditor credibility. Untabulated results suggest that the correlation between jurors' assessments of auditor causal influence on the audit failure and jurors' assessments of auditor credibility is not significant ($p = 0.473$). Participants were also asked to evaluate, on the 101-point scale from 0 (Completely disagree) to 100 (Completely agree), whether they believe that the lead audit firm intends to shirk audit responsibility for the audit of the subsidiary (Responsibility Shirk). I use *Responsibility Shirk* to elaborate on the negative hypothesized effect of dividing audit responsibility on *Perceived Auditor Credibility*.

[Insert Table 4 and Table 5 Here]

I estimate the structural equation model (SEM) in Figure 3 to test the theorized model. SEM analysis allows simultaneous analysis of multiple regressions. I use a nested model comparison to test whether the effect of audit responsibility assignment varies with audit failure location. The model fits in the data well ($\chi^2 = 4.280$, $df = 5$, $p = 0.510$, $CFI = 0.980$, $RMSEA = 0.004$).^{17, 18} The path coefficients shown in Figure 3 provide empirical support for the theorized process. The effect of audit responsibility assignment on jurors' assessments of auditor causal influence (Link1) and auditor credibility (Link 2 and 4) is

¹⁷ The model uses jurors' negligence verdicts as the dependent variable. Inferences from the theorized model do not change when a continuous negligence measure or damages assessments measure is used. For the convenience of comparisons, I report standardized coefficients.

¹⁸ To indicate a model with good fit, the Chi-square statistic should have a p-value above 0.05; the comparative fit index (CFI) should have a value greater than 0.90, and preferably over 0.95; and the root mean square error of approximation (RMSEA) should be below 0.10, and preferably under 0.08 (Byrne 2010).

conditional on auditor failure location. Specifically, when the audit failure location is the lead audit firm, dividing audit responsibility does not impact jurors' assessments of auditor causal influence on the audit failure (Link 1: coefficient = -0.070, $p = 0.170$, one-tailed). However, it increases jurors' impression that auditors intend to shirk audit responsibility (Link 2: coefficient = 0.500, $p < 0.001$, one-tailed) and thus damages jurors' assessments of auditor credibility (Link 4: coefficient = -0.460, $p < 0.001$, one-tailed). When the audit failure location is the participating audit firm, dividing audit responsibility reduces jurors' assessments of causal influence on the audit failure (Link 1: Coefficient = -0.598, $p < 0.001$, one-tailed). It moderately increases jurors' assessments of responsibility shirk (Link 2: coefficient = 0.151, $p = 0.080$, one-tailed) and reduces jurors' assessments of auditor credibility (Link 4: coefficient = -0.460, $p < 0.001$, one-tailed).

Link 3 and link 5 estimates show that jurors' assessments of auditor causal influence on the audit failure and auditor credibility are two determinants of their negligence verdicts. *Causal influence* is positively related to jurors' negligence verdicts (Link 3: Coefficient = 0.380, $p < 0.001$, one-tailed). This finding suggests that jurors tend to blame auditors to a greater extent when they perceive auditors have stronger causal influence on the audit failure. *Perceived auditor credibility* is negatively related to jurors' negligence verdicts (Link 5: Coefficient = -0.760, $p < 0.001$, one-tailed). When jurors perceive auditors as credible, they tend to blame auditors less for the audit failure.

[Insert Figure 3 Here]

These results support the overall process underlying hypotheses. Dividing audit responsibility with the participating audit firm reduces the litigation risk of the lead audit firm when the audit failure location is the participating audit firm because it reduces jurors' assessments of auditor causal influence on the audit failure.¹⁹ However, dividing audit responsibility backfires to increase the lead audit firm's litigation risk when the audit failure is caused by the lead audit firm because it damages jurors' assessments of auditor credibility.

Path Analysis: Testing the Mediating Role of Perceived Auditor Credibility for the Engagement Partner Signature Effect

The main test shows that an engagement partner signature on the audit report reduces jurors' negligence verdicts. In this section, I conduct a mediation analysis to further understand the mechanism responsible for this effect. My theory proposes that an engagement partner signature has no impact on jurors' assessments of auditor causal influence over the audit failure, but it improves jurors' assessments of auditor credibility and thus alleviates jurors' negligence verdicts. To examine my theory, I perform two ANOVA tests with *engagement partner signature* as the independent variable, and *causal influence* and *perceived auditor credibility* as two dependent variables. I find that engagement partner

¹⁹ Model estimates show that when the audit failure location is the participating audit firm, dividing audit responsibility negatively impacts jurors' assessments of the lead audit firm's credibility. However, this negative effect is reduced compared to when the audit failure location is the lead audit firm. I find that *Perceived Auditor Credibility* under the condition of dividing audit responsibility is 48.810 for participating audit firm's audit failure and 41.961 (see Table 5) for lead audit firm's audit failure ($p = 0.039$, one-tailed). This is consistent with my theory that the audit failure caused by the participating audit firm rationalizes the choice made by the lead audit firm to divide audit responsibility with the participating audit firm and thus positively impacts jurors' assessments of the lead audit firm's credibility.

signature has no impact on jurors' assessments of auditor causal influence on the audit failure ($F = 0.400$, $df = 1$, $p = 0.360$, untabulated), but significantly improves jurors' assessments of auditor credibility ($F = 3.798$, $df = 1$, $p = 0.024$, untabulated).²⁰ These findings are consistent with my theory.

Next, I conduct the SEM analysis with *engagement partner signature* as the independent variable, *perceived auditor credibility* as the intervening variable, and jurors' negligence verdicts as the dependent variable. Figure 4 displays the process model. This model has adequate fit ($\chi^2 = 0.077$, $df = 1$, $p = 0.742$, CFI = 1.000, RMSEA < 0.001). I find that as predicted, an engagement partner signature positively impacts jurors' assessments of auditor credibility (Coefficient = 0.360, $p = 0.001$, one-tailed), suggesting that relative to the audit firm signature, an engagement partner signature leads to an increase in jurors' assessments of auditor credibility. In turn, increased auditor credibility perceived by jurors due to the engagement partner signature reduces juror's negligence verdicts (Coefficient = -0.530, $p < 0.001$, one-tailed). These results suggest that the effect of an engagement partner signature on jurors' negligence verdicts operates through its effect on jurors' assessments of auditor credibility.

[Insert Figure 4 Here]

4.5 Jurors' Negligence Judgments of the Participating Audit Firm

²⁰ I also ask participants to indicate to how much they experience positive/negative feeling towards M LLP, on a 101-point scale with endpoints 0 = "no positive/negative feeling" and 100 = "very strong positive/negative feeling." Results show that jurors have neither strong positive feeling (mean = 17.213) nor strong negative feeling (mean = 14.259; $t = 0.751$, $p = 0.226$) towards the M LLP. These results suggest that engagement partner signature has a trivial impact on jurors' affect (i.e., negative/positive feeling) towards the lead audit firm.

I use the same questions to measure jurors' negligence judgments of the participating audit firm as those to measure their negligence judgments of the lead audit firm. The results are presented from Table 6 to Table 8. I find that the audit failure location has a significant effect on jurors' negligence verdicts of the participating audit firm ($\chi^2 = 42.284$, $df = 1$, $p < 0.001$, two-tailed). Specifically, jurors return more negligence verdicts against the participating audit firm when the audit failure is caused by the participating audit firm than by the lead audit firm (50.7 percent vs. 15.3 percent, $\chi^2 = 17.263$, $df = 1$, $p < 0.001$, one-tailed, untabulated). This finding holds when using alternative dependent measures.

[Insert Table 6 to Table 8 Here]

My theory predicts that the participating audit firm will not be liable for an audit failure caused by the lead audit firm. To examine this conjecture, I ask participants to evaluate whether the participating audit firm is negligent for an audit failure caused by the lead audit firm. Untabulated results show that the sample mean of jurors' negligence verdicts of participating audit firms is not significantly higher than zero (mean = 15.3 percent, $p = 0.222$) when the audit failure location is the lead audit firm. This finding suggests that jurors are unlikely to give unfavourable verdicts to the participating audit firm when the audit failure is caused by the lead audit firm. These results are consistent with my theory.

5. CONCLUSION

In this thesis, I investigate the effects of three important aspects present in group audits on the lead audit firm's litigation risk: the approach in which the

lead audit firm assigns audit responsibility, the location where the audit failure occurs, and an engagement partner signature on the group audit report. My thesis presents evidence that dividing audit responsibility with participating audit firms does not necessarily reduce the lead audit firm's litigation risk. Specifically, it reduces jurors' assessments of auditor causal influence on the audit failure related to the audit area of the participating audit firm, but it increases the lead audit firm's liability when the audit failure is found in the audit area of the lead audit firm. I further examine whether and how an engagement partner signature on the audit report influences jurors' negligence verdicts. I find that, relative to the audit firm signature, an engagement partner signature reduces jurors' negligence verdicts.

Consistent with my predictions informed by the story model for juror decision-making, I find that jurors' negligence verdicts are determined by jurors' assessments of auditor causal influence on the audit failure and auditor credibility. Dividing audit responsibility reduces jurors' assessments of auditor causal influence on the audit area of the participating audit firm, but also damages jurors' assessments of auditor credibility. An engagement partner signature has no impact on jurors' assessments of auditor causal influence on the audit failure. Instead, it increases jurors' assessments of auditor credibility.

This thesis contributes to accounting literature in several ways. It provides initial evidence on how dividing audit responsibility in group audits affects the lead audit firm's litigation risk. Prior studies focus on its effects on audit quality and audit fees (Dee et al. 2015; Mao, Ettredge, and Stone 2019). Capitalizing on

the experimental method's advantages, this thesis provides theory and evidence suggesting that dividing audit responsibility with participating audit firm may backfire to damage credibility and increase liability. This finding informs the public debate on the disclosure of other audit participants and their respective responsibility scope. Furthermore, this thesis shows that an engagement partner signature reduces the lead audit firm's litigation risk by enhancing perceived auditor credibility.

The lead audit firm has the discretion to either assume or divide audit responsibility with participating audit firms (PCAOB 2016). Intuitively, dividing audit responsibility is supposed to constrain auditor' litigation risk. This thesis presents cautions against this argument. Given the complexities of certain audits (e. g., multinational audits), the lead audit firm may not assume audit responsibility for participating audit firms. In such scenarios, jurors are apt to "set a higher bar" for auditors. Specifically, after the lead audit firm divides audit responsibility with the participating audit firm, if it still causes an audit failure, jurors tend to blame the lead audit firm.

This thesis also contributes to the research on signatures and has implications for researchers who use personal name signatures as proxies for conceptual variables. For example, personal name signatures have been used as proxies for narcissism (Ham, Lang, Seybert, and Wang 2017; Ham, Seybert, and Wang 2018). While prior works tend to view certain characteristics of personal name signatures (e.g., signature size) as indicators of negative individual traits, my results suggest that recipients of signatures do not view signatures negatively

per se. On the contrary, I find that, in my experiment, jurors perceive the auditor as more credible when the auditor signs (versus does not sign) his/her personal name on the audit report. In this sense, personal name signatures will benefit those who make such signatures. These findings are of interest to financial statement users who are frequently exposed to auditor and management signatures.

This thesis is subject to limitations. First, auditors must abide by rules of professional conduct and exercise professional skepticism. The fact that the lead audit firm divides audit responsibility with participating audit firms is perhaps a strong signal that negatively impacts their credibility. However, this finding may not be generalized to other settings. For instance, management may use “reasonable assurance” or other plausible excuses to disclaim responsibility (Tan and Yu 2018). These statements may be persuasive due to the volatility of external business and the complexity of internal control. Second, in my experimental setting, the group audit involves only one participating audit firm, but in practice, a group audit may involve multiple participating audit firms. The litigation impact of responsibility assignment in group audits is not likely to differ when there is one versus multiple participating audit firms. Nonetheless, the involvement of more participating audit firms will pose greater difficulty to the lead audit firm in its supervision of participating audit firms in a group audit (PCAOB 2016). Therefore, the lead audit firm may be less willing to assume full audit responsibility for the entire audit engagement. Future research can explore how the lead audit firm makes responsibility assignment decisions and whether

this decision determines the level of supervision exercised by the lead audit firm and the overall quality of the group audit. Third, Mao et al. (2019) document that lead audit firms assuming full audit responsibility for the entire audit engagement are associated with higher audit fees than those dividing audit responsibility with participating audit firms. In my experiment, I do not provide participants with the information of audit fees. However, I do not expect that results of my experiment and implications of this study will differ if jurors consider different levels of audit fees. A higher audit fees charged by the lead audit firm will increase jurors' expectation of audit quality provided by the lead audit firm. In such case, an audit failure, no matter it is caused by the lead audit firm or the participating audit firm, will violate jurors' expectation and lead to increased negligence verdicts. Therefore, I predict that audit fees will have a positive main effect on jurors' negligence verdicts. Future research can examine my conjectures and explore how audit fees impact jurors' negligence verdicts.

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FIGURE 1
Theoretical Model of Audit Responsibility Assignment Effect on Jurors' Negligence Verdicts

Note: This theorized model shows how audit responsibility assignment affects jurors' assessments of auditor causal influence on the audit failure, intention of responsibility shirk, auditor credibility, and their negligence verdicts under varying audit failure location. The links denoted with an asterisk (*) depend on audit failure location.

FIGURE 2
The Interaction Effect of Audit Responsibility Assignment and Audit Failure Location on Jurors' Negligence Verdicts

Panel A: Jurors' Negligence Verdicts under Audit Firm Signature

Panel B: Jurors' Negligence Verdicts under Engagement Partner Signature

FIGURE 3
Empirical Model of Audit Responsibility Assignment Effect on Jurors' Negligence Verdicts

Note: This figure shows structural-equation modeling results for the mediating roles of Causal Influence and Perceived Auditor Credibility for Audit Responsibility Assignment (from 0 = Assume to 1 = Divide) effect on Jurors' Negligence Verdicts (Negligent or Not Negligent). Overall model fit indices are as follows: (a) $\chi^2 = 4.280$, $df = 5$ and $p = 0.510$, (b) comparative fit index (CFI) = 0.980, and (c) root mean square error of approximation (RMSEA) value = 0.004. This model allows Link 1 and Link 2 to vary across audit failure location because nested-model comparisons suggest significantly better model fit when links vary ($\chi^2 = 6.210$, $df = 2$ and $p = 0.040$), indicating a significant interaction of Audit Responsibility Assignment and Audit Failure Location. All coefficients are standardized coefficients. All p-values are one-tailed given my directional predictions.

FIGURE 4
The Mediating Role of Perceived Auditor Credibility for the Engagement Partner Signature Effect

Note: This figure shows structural-equation modeling results for the mediating role of Perceived Auditor Credibility for the Engagement Partner Signature (from 0 = audit firm signature to 1 = engagement partner signature) effect on Jurors' Negligence Verdicts (Negligent or Not Negligent). Overall model fit indices are as follows: (a) $\chi^2 = 0.077$, $df = 1$ and $p = 0.742$, (b) comparative fit index (CFI) = 1.000, and (c) root mean square error of approximation (RMSEA) value < 0.001. All coefficients are standardized coefficients. All p-values are one-tailed given my directional predictions.

TABLE 1
Jurors' Negligence Verdicts of the Lead Audit Firm

Panel A. Descriptive statistics of jurors' negligence verdicts

Audit responsibility assignment	Audit firm signature		Engagement partner signature	
	M LLP's audit failure	S LLP's audit failure	M LLP's audit failure	S LLP's audit failure
Divide audit responsibility	31/38 (81.6%)	8/36 (22.2%)	20/36 (55.5%)	2/36 (5.5%)
Assume audit responsibility	16/36 (44.4%)	18/40 (45.0%)	10/40 (25.0%)	10/38 (26.3%)

Panel B. Generalized Linear Model (Logit Link, Binomial Distribution) for Verdicts

Source of variation	df	Chi-Square	p-value
Audit responsibility assignment (R)	1	0.022	0.883
Audit failure location (L)	1	22.294	0.000
Engagement partner signature (S)	1	14.176	0.000
R × L	1	23.746	0.000
R × S	1	0.891	0.345
L × S	1	0.050	0.824
R × L × S	1	0.090	0.764

Panel C. Planned comparison tests of audit responsibility assignment

	Audit failure location	Contrast value	p-value*
Audit firm signature: Divide vs. Assume	M LLP	37.20%	0.001
	S LLP	-22.80%	0.019
Engagement partner signature: Divide vs. Assume	M LLP	30.60%	0.001
	S LLP	-20.80%	0.018

Panel D. Planned comparison tests of engagement partner signature

	Audit failure location	Contrast value	p-value*
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Divide audit responsibility:			
Audit firm signature vs.	M LLP	26.00%	0.003
engagement partner signature	S LLP	16.70%	0.040

Assume audit responsibility:			
Audit firm signature vs.	M LLP	19.40%	0.038
engagement partner signature	S LLP	18.70%	0.042

Table 1 presents the results of jurors' negligence verdicts. Panel A presents descriptive statistics of jurors' verdicts judgments. Panel B presents the results of the generalized linear model. Panel C presents the planned comparison tests for audit responsibility assignment effect. Panel D presents the planned comparison tests for engagement partner signature effect.

Variable Definitions:

Negligence verdicts = an indicator variable that takes the value of 1 if the participant returned a verdict against the auditor, and 0 if the participant returned a verdict in favor of the auditor;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

* p-values are one-tailed for directional predictions, and all other p-values are two-tailed.

TABLE 2
Jurors' Negligence Evaluations of the Lead Audit Firm

Panel A. Descriptive statistics of jurors' negligence evaluations: mean, (SD), [n]

Audit responsibility assignment	Audit firm signature		Engagement partner signature	
	M LLP's audit failure	S LLP's audit failure	M LLP's audit failure	S LLP's audit failure
Divide audit responsibility	66.658 (28.430) [38]	26.889 (28.523) [36]	51.000 (34.634) [36]	13.361 (26.736) [36]
Assume audit responsibility	48.528 (36.407) [36]	46.175 (31.722) [40]	31.950 (24.759) [40]	31.737 (30.584) [38]

Panel B. Three-Way ANOVA

Source of variation	df	F	p-value
Audit responsibility assignment (R)	1	0.001	0.972
Audit failure location (L)	1	35.179	0.000
Engagement partner signature (S)	1	19.934	0.000
R × L	1	30.809	0.000
R × S	1	0.018	0.892
L × S	1	0.100	0.752
R × L × S	1	0.000	0.999
Error	292		

Panel C. Planned comparison tests of audit responsibility assignment

	Audit failure location	Contrast value	p-value*
Audit firm signature:			
Divide vs. Assume	M LLP	18.130	0.007
	S LLP	-19.286	0.004
Engagement partner signature:			
Divide vs. Assume	M LLP	19.050	0.001
	S LLP	-18.376	0.002

Panel D. Planned comparison tests of engagement partner signature

	Audit failure location	Contrast value	p-value*
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Divide audit responsibility:			
Audit firm signature vs.	M LLP	15.658	0.007
engagement partner signature	S LLP	13.528	0.018
Assume audit responsibility:			
Audit firm signature vs.	M LLP	16.578	0.010
engagement partner signature	S LLP	14.438	0.021

Table 2 presents the results of jurors' negligence evaluations on the 101-point continuous scale. Panel A presents descriptive statistics of jurors' negligence evaluations. Panel B presents the three-way ANOVA results. Panel C shows the planned comparison tests for audit responsibility assignment effect. Panel D presents the planned comparison tests for engagement partner signature effect.

Variable Definitions:

Negligence evaluations = Participants' likelihood evaluations of whether the audit firm was negligent on a scale from 0 = certainly not negligent to 100 = certainly negligent;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

* p-values are one-tailed for directional predictions, and all other p-values are two-tailed.

TABLE 3
Jurors' Damage Assessments of the Lead Audit Firm

Panel A. Descriptive statistics of jurors' damage assessments: mean, (SD), [n]

Audit responsibility assignment	Audit firm signature		Engagement partner signature	
	M LLP's audit failure	S LLP's audit failure	M LLP's audit failure	S LLP's audit failure
Divide audit responsibility	5.368 (3.141) [38]	2.419 (2.427) [36]	4.028 (2.510) [36]	0.267 (2.370) [36]
Assume audit responsibility	4.133 (3.577) [36]	3.965 (3.183) [40]	2.503 (2.177) [40]	2.768 (3.386) [38]

Panel B. Three-Way ANOVA

Source of variation	df	F	p-value
Audit responsibility assignment (R)	1	1.013	0.315
Audit failure location (L)	1	26.750	0.000
Engagement partner signature (S)	1	24.442	0.000
R × L	1	28.353	0.000
R × S	1	0.271	0.603
L × S	1	0.087	0.768
R × L × S	1	0.950	0.330
Error	292		

Panel C. Planned comparison tests of audit responsibility assignment

	Audit failure location	Contrast value	p-value*
Audit firm signature:			
Divide vs. Assume	M LLP	1.235	0.045
	S LLP	-1.546	0.016
Engagement partner signature:			
Divide vs. Assume	M LLP	1.525	0.003
	S LLP	-2.502	0.000

Panel D. Planned comparison tests of engagement partner signature

	Audit failure location	Contrast value	p-value*
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Divide audit responsibility:			
Audit firm signature vs. engagement partner signature	M LLP	1.341	0.008
	S LLP	2.153	0.000

Assume audit responsibility:			
Audit firm signature vs. engagement partner signature	M LLP	1.631	0.012
	S LLP	1.197	0.045

Table 3 presents the results of jurors' damage award assessments. Panel A presents descriptive statistics of jurors' damage assessments. Panel B presents the three-way ANOVA results. Panel C presents the planned comparison tests for audit responsibility assignment effect. Panel D presents the planned comparison tests for engagement partner signature effect.

Variable Definitions:

Damage assessments = participants' assessments of damage on a scale from \$0 to \$9 million;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

* p-values are one-tailed for directional predictions, and all other p-values are two-tailed.

TABLE 4
Jurors' Assessments of Causal Influence

Panel A. Descriptive statistics of jurors' assessments of causal influence: mean, (SD), [n]

Audit responsibility assignment	Audit firm signature		Engagement partner signature	
	M LLP's audit failure	S LLP's audit failure	M LLP's audit failure	S LLP's audit failure
Divide audit responsibility	41.973 (30.781) [38]	24.047 (25.742) [36]	41.576 (36.305) [36]	22.969 (21.437) [36]
Assume audit responsibility	42.955 (36.131) [36]	39.923 (35.399) [40]	42.752 (37.555) [40]	39.807 (35.453) [38]

Panel B. Three-Way ANOVA

Source of variation	df	F	p-value
Audit responsibility assignment (R)	1	1.283	0.258
Audit failure location (L)	1	17.575	0.000
Engagement partner signature (S)	1	1.245	0.265
R × L	1	7.564	0.006
R × S	1	0.455	0.500
L × S	1	0.349	0.555
R × L × S	1	0.088	0.767
Error	292		

Panel C. Planned comparison tests of audit responsibility assignment

	Audit failure location	Contrast value	p-value
Audit firm signature:			
Divide vs. Assume	M LLP	-0.982	0.900
	S LLP	-15.876	0.015*
Engagement partner signature:			
Divide vs. Assume	M LLP	-1.176	0.890
	S LLP	-16.838	0.008*

Panel D. Planned comparison tests of engagement partner signature

	Audit failure location	Contrast value	p-value
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Divide audit responsibility:			
Audit firm signature vs.	M LLP	0.397	0.960
engagement partner signature	S LLP	1.078	0.847

Assume audit responsibility:			
Audit firm signature vs.	M LLP	0.203	0.981
engagement partner signature	S LLP	0.116	0.988

Table 4 presents the results of jurors' assessments of auditor causal influence over the audit failure. Panel A presents descriptive statistics of jurors' assessments of causal influence. Panel B presents the ANOVA results. Panel C presents the planned comparison tests for audit responsibility assignment effect. Panel D presents the planned comparison tests for engagement partner signature effect.

Variable Definitions:

Jurors' Assessments of Causal Influence = the average of participants' assessments of auditors' causation and foreseeability of the audit failure;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

* p-values are one-tailed for directional predictions, and all other p-values are two-tailed.

TABLE 5
Jurors' Assessments of Auditor Credibility

Panel A. Descriptive statistics of jurors' assessments of credibility: mean, (SD), [n]

Audit responsibility assignment	Audit firm signature		Engagement partner signature	
	M LLP's audit failure	S LLP's audit failure	M LLP's audit failure	S LLP's audit failure
Divide audit responsibility	41.961 (28.844) [38]	48.810 (25.361) [36]	51.228 (25.594) [36]	60.714 (22.797) [36]
Assume audit responsibility	57.607 (30.542) [36]	59.863 (32.350) [40]	70.766 (25.559) [40]	70.931 (31.198) [38]

Panel B. Three-Way ANOVA

Source of variation	df	F	p-value
Audit responsibility assignment (R)	1	5.943	0.015
Audit failure location (L)	1	2.789	0.096
Engagement partner signature (S)	1	8.210	0.004
R × L	1	1.973	0.161
R × S	1	0.025	0.874
L × S	1	0.443	0.506
R × L × S	1	0.204	0.652
Error	292		

Panel C. Planned comparison tests of audit responsibility assignment

	Audit failure location	Contrast value	p-value*
Audit firm signature:			
Divide vs. Assume	M LLP	-15.647	0.007
	S LLP	-11.053	0.026
Engagement partner signature:			
Divide vs. Assume	M LLP	-19.538	0.001
	S LLP	-10.217	0.028

Panel D. Planned comparison tests of engagement partner signature

	Audit failure location	Contrast value	p-value*
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Divide audit responsibility:			
Audit firm signature vs.	M LLP	-9.267	0.038
engagement partner signature	S LLP	-11.904	0.010
Assume audit responsibility:			
Audit firm signature vs.	M LLP	-13.159	0.011
engagement partner signature	S LLP	-11.068	0.032

Table 5 presents the results of jurors' assessments of auditor credibility. Panel A presents descriptive statistics of jurors' assessments of auditor credibility. Panel B presents the ANOVA results. Panel C presents the planned comparison tests for audit responsibility assignment effect. Panel D presents the planned comparison tests for engagement partner signature effect.

Variable Definitions:

Jurors' Assessments of Auditor Credibility = the average of participants' assessments of competence and trustworthiness of the lead audit firm;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

* p-values are one-tailed for directional predictions, and all other p-values are two-tailed.

TABLE 6
Jurors' Negligence Verdicts of the Participating Audit Firm

Panel A. Negligence verdicts under audit firm signature

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	8/38 (21.1%)	23/36 (63.9%)	31/74 (41.9%)
Assume responsibility	6/36 (16.6%)	18/40 (45.0%)	24/76 (31.5%)
Collapsed across audit responsibility assignment	14/74 (18.9%)	41/76 (53.9%)	55/150 (36.6%)

Panel B. Negligence verdicts under engagement partner signature

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	4/36 (11.1%)	21/36 (58.3%)	25/72 (34.7%)
Assume responsibility	5/40 (12.5%)	14/38 (36.8%)	19/78 (24.4%)
Collapsed across audit responsibility assignment	9/76 (11.8%)	35/74 (47.3%)	44/150 (29.3%)

Panel C. Generalized Linear Model (Logit Link, Binomial Distribution) for Verdicts

Source of variation	df	Chi-Square	p-value (two-tailed)
Audit responsibility assignment (R)	1	2.007	0.121
Audit failure location (L)	1	42.284	0.000
Engagement partner signature (S)	1	0.521	0.471
R × L	1	0.335	0.563
R × S	1	0.825	0.364
L × S	1	0.048	0.827
R × L × S	1	1.166	0.280

Table 6 presents participants' negligence verdicts of the participating audit firm. All p-values are two-tailed.

Variable Definitions: *Negligence verdicts* = an indicator variable that takes the value of 1 if the participant returned a verdict against the auditor, and 0 if the participant returned a verdict in favor of the auditor;

Audit responsibility assignment = the type of the lead audit firm assigning audit responsibility at two levels;

Audit failure location = the audit failure was perpetrated by the lead audit firm or participating audit firm; and

Engagement partner signature = the engagement partner from the lead audit firm signs the audit report in personal name or audit firm's name.

TABLE 7
Jurors' Negligence Evaluations of the Participating Audit Firm

Panel A. Negligence evaluations under audit firm signature: Mean, (SD), [n]

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	19.320 (28.430) [38]	49.060 (30.677) [36]	33.897 (29.523) [74]
Assume responsibility	15.021 (25.645) [36]	50.331 (36.295) [40]	32.675 (29.677) [76]
Collapsed across audit responsibility assignment	17.273 (27.152) [74]	49.625 (34.011) [76]	33.187 (30.196) [150]

Panel B. Negligence evaluations under engagement partner signature: Mean, (SD), [n]

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	15.310 (23.505) [36]	54.440 (30.517) [36]	34.236 (27.491) [72]
Assume responsibility	16.972 (28.789) [40]	42.139 (37.030) [38]	29.545 (32.784) [78]
Collapsed across audit responsibility assignment	15.929 (26.538) [76]	48.365 (34.082) [74]	32.149 (29.699) [150]

Panel C. Three-Way ANOVA

Source of variation	df	F	p-value (two-tailed)
Audit responsibility assignment (R)	1	0.945	0.332
Audit failure location (L)	1	84.400	0.000
Engagement partner signature (S)	1	0.118	0.731
R × L	1	0.356	0.551
R × S	1	0.291	0.590
L × S	1	0.003	0.956

$R \times L \times S$	1	1.931	0.166
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Table 7 presents participants' negligence evaluations of the participating audit firm on a 101-point continuous scale. All p-values are two-tailed.

Variable Definitions: *Negligence evaluations*= *Participants' likelihood evaluations of whether the audit firm was negligent on a scale from 0= certainly not negligent to 100=certainly negligent*;

TABLE 8
Jurors' Damage Assessments of the Participating Audit Firm

Panel A. Damage assessments under audit firm signature: Mean, (SD), [N]

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	1.105 (2.013) [38]	3.689 (2.640) [36]	2.405 (2.371) [74]
Assume responsibility	0.994 (2.289) [36]	2.867 (2.814) [40]	1.931 (2.536) [76]
Collapsed across audit responsibility assignment	1.021 (2.134) [74]	3.257 (2.726) [76]	2.135 (2.424) [150]

Panel B. Damage assessments under engagement partner signature: Mean, (SD), [N]

Audit responsibility assignment	Audit failure location		
	M LLP's audit failure	S LLP's audit failure	Collapsed across audit failure location
Divide responsibility	0.869 (1.974) [36]	3.975 (3.318) [36]	2.459 (2.635) [72]
Assume responsibility	1.095 (2.387) [40]	2.216 (2.884) [38]	1.676 (2.631) [78]
Collapsed across audit responsibility assignment	0.981 (2.180) [76]	3.145 (3.002) [74]	2.037 (2.632) [150]

Panel C. Three-Way ANOVA

Source of variation	df	F	p-value (two-tailed)
Audit responsibility assignment (R)	1	1.932	0.144
Audit failure location (L)	1	53.149	0.000
Engagement partner signature (S)	1	0.177	0.674
R × L	1	1.121	0.241
R × S	1	0.255	0.614
L × S	1	0.037	0.847

$R \times L \times S$	1	1.145	0.286
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Table 8 presents participants' damage award assessments of the participating audit firm. All p-values are two-tailed.

Variable Definitions: Damage assessments= participants' assessments of damage on a scale from \$0 to \$9 million.

APPENDIX: EXPERIMENT INSTRUMENT

Screening Questions

1. Are you at least 18 years of age and a United States Citizen?
 - ☐ Yes
 - ☐ No
2. Have you ever served on a jury before?
 - ☐ Yes
 - ☐ No
3. Was the case a financial crime?
 - ☐ Yes
 - ☐ No
4. Have you ever worked for a bank or other lending institution?
 - ☐ Yes
 - ☐ No
5. Have you ever worked as an auditor?
 - ☐ Yes
 - ☐ No
6. Have you ever worked as an accountant?
 - ☐ Yes
 - ☐ No
7. Have you ever worked as a lawyer or for a law firm?
 - ☐ Yes
 - ☐ No
8. Have you ever worked for the Environmental Protection Agency (EPA)?
 - ☐ Yes
 - ☐ No
9. Have you ever worked for a mining/gravel company?
 - ☐ Yes
 - ☐ No

Instructions: In this project, you will first read background information about financial statements and the audit process. Next, you will read a case describing the audit of a company and the outcome of that audit. **It is important that you read all case materials carefully and answer the included questions thoughtfully and honestly.** Throughout the case, you will be required to answer the following three types of questions:

- **Review Questions** will reflect whether you read and understand the presented material. These questions will not be difficult if you read the materials carefully.
- **Case Questions** will ask you for your judgments about the outcomes of the audit described in the case
- **Wrap-up Questions** will ask you some miscellaneous and survey-style questions.

You are allowed to review previous pages of the case when answering the review and case questions.

Financial Statements

- Companies prepare financial statements for investors, lenders, and other users.
- Investors and lenders use the financial statements to assess the financial “health” of the company to determine whether or not to invest or loan the company money.
- Financial statements provide information about a company’s assets and liabilities on a **Balance Sheet**.
- **Assets** refer to items of value that a company owns. For example, cash, inventory, property, and equipment are all assets.
- **Liabilities** refer to debts that the company owes to other entities. For example, if a company borrowed \$1,000,000 from a bank, they would have a liability of \$1,000,000 until they repaid the money to the bank.
- Increasing the total amount of assets a company owns relative to the amount of liabilities they owe **decreases** the risk of that company going bankrupt or completely out of business, i.e., **increasing** assets relative to liabilities improves the financial “health” of a company.
- Financial statements also report a company’s performance over the past year in an **income statement**.
- The income statement reports the income and expenses of a company as well as the net income.
- **Net income** refers to the difference between a company’s **revenues and its expenses**. For example, if a company had \$10,000,000 in sales revenue last year and the total expenses incurred for the year were \$9,000,000, its net income for that year would be \$1,000,000.
- Higher net income increases assets and decreases liabilities, improving the financial health of the company.

- A company's financial statements might be misstated. **Misstatements** include both unintentional errors and intentional (fraudulent) misrepresentations by the company's management.
- Financial statements sometimes contain **material misstatements**. Material misstatements are those misstatements included in financial statements that are large enough to change the decisions of people who use the financial statements for lending and investing decisions.

Review Questions

1. Investors and lenders use a company's financial statements when making decisions about whether to invest in and loan money to that company.
 - True
 - False
2. Assets refer to debts that a company owes to other entities.
 - True
 - False
3. Increasing assets relative to liabilities improves the financial health of a company.
 - True
 - False
4. Financial statements **never** contain a material misstatement.
 - True
 - False
5. Material misstatements are errors and misrepresentations in the financial statements that are large enough to change the decisions of people using the financial statements for lending and investing decisions.
 - True
 - False

Auditing

- Companies hire **external auditors** (i.e., people from outside of the company) to verify the accuracy of their financial statements.
- Auditors examine the financial statements and express an opinion about the accuracy of the financial statements. An **unqualified audit opinion** should give people who use the financial statements **reasonable assurance** that the financial statements do not have material misstatements. Another name for an unqualified audit opinion is a "**clean**" audit opinion.
- Reasonable assurance is **not** the same as **absolute assurance**. In particular, reasonable assurance conveys a high, but not an absolute, level of assurance that the financial statements are free from material misstatement. So, even after a good audit is performed, a company's financial statements could **still** contain a misstatement.
- A good audit is performed when auditors exercise **due professional care**. Auditors exercise due professional care when they follow auditing standards and take actions consistent with what other prudent auditors would have done in the given situation. Auditors do not always exercise due professional care. If auditors fail to exercise due professional care, they are **negligent**.

- Even good **audits are not perfect**. An auditor can perform a good audit and exercise due professional care and still fail to detect material misstatements. In other words, just because an audit fails to detect material misstatements, it does not necessarily mean the auditors were negligent.
- Of course, financial statements are **less likely** to contain a material misstatement if auditors perform a good audit than if they are negligent.

Review Questions (Auditing)

- Auditors **always** exercise due professional care.
 - True
 - False
- Material misstatements **never** remain in the financial statements once auditors who exercise due professional care audit the financial statements.
 - True
 - False
- Financial statements are more likely to contain a material misstatement if auditors are negligent.
 - True
 - False
- Reasonable assurance is **NOT** the same as absolute assurance.
 - True
 - False

The Importance of Financial Statements and Audits

- Accurate financial statements are important because material misstatements can cause enormous losses of money, as in the Enron, WorldCom, and Madoff cases.
 - Investors and lenders who rely on materially misstated financial statements may make decisions they would not have made if the financial statements were accurate. These decisions may result in a financial loss.
 - Employees of the company may also lose their jobs and life savings.
- It is **critical to society that auditors exercise due professional care while auditing** and only issue clean audit opinions when they believe financial statements are **NOT** materially misstated.
- **Audit failures** occur when the auditors issue an unqualified “clean” opinion for financial statements that are materially misstated.
- When an audit failure occurs, **investors and lenders who lost money because they relied on materially misstated financial statements often sue the auditors** for negligence to recover the money they lost.
- When this occurs, jurors are chosen from the general public to determine if the auditors were negligent in performing the audit. To make this determination, the jury only needs to consider whether the auditor exercised due professional care. If the auditor did not exercise due professional care, the auditor was negligent.

- If the jury finds that the auditors were **negligent**, the auditors will be held responsible for compensating the plaintiffs, i.e., the investors and lenders who lost money because of their reliance on the misstated financial statements.
- If the jury finds that the auditors were **not negligent**, the auditors will not be required to pay any damages.

Review Questions

10. Which of the following can happen when a company's financial statements include a material misstatement?
 - Investors and lenders who rely on the financial statements with the undetected material misstatement can lose their money
 - Employees of the company can lose their jobs and their life savings
 - Both of the above can happen
11. When an audit failure occurs, investors and lenders often sue the auditor for negligence to recover the money they lost.
 - True
 - False
12. To determine if the auditors were negligent, jurors must determine if:
 - The auditors were connected to prior audit failures
 - The auditors exercised due professional care in performing the audit
 - The auditors overcharged the client for their services

Audit responsibility assignment

- Many audit engagements require multiple audit firms; in such audits, although one audit firm issues the audit report, important audit work is often performed by other independent audit firms.
- The audit firm that issues the final audit report is called **lead audit firm**, and the audit firm that participates in the audit and performs a component of audit work is called **participating audit firm (or other audit firms)**.
- One typical case is the audit of a company that has a subsidiary.
- The lead audit firm is responsible for auditing the financial statement of the **holding company (or parent company)**; the participating audit firm is responsible for auditing the financial statement of the **subsidiary**.
- Based on its own audit on the holding company and the audit opinion about the subsidiary offered by the participating audit firm, **the lead audit firm will issue the final consolidated audit report**.
- Given that a component of audit is performed by another independent audit firm, the lead audit firm needs to consider **how to assign audit responsibility** with the participating audit firm. Under current auditing standards, the lead audit firm has two options:
 - **The lead audit firm may divide responsibility for the audit with the participating audit firm.** When the lead audit firm divides responsibility (i.e., splits responsibility) for the audit with the participating audit firm, its audit report should make reference to the audit of the participating audit firm and indicate clearly the

division of audit responsibility between the lead audit firm and the participating audit firm in expressing audit opinions on the financial statements.

- **The lead audit firm may assume audit responsibility for the work performed by the participating audit firm.** If the lead audit firm takes this position, it should express an opinion on the financial statements taken as a whole without making reference in its report to the audit work performed by the participating audit firm.

Review Questions

13. Which of the following arguments is **False**?

- An audit engagement can be finished by a group of audit firms
- The lead audit firm does not audit every single financial statement of the client, and the participating audit firm helps the lead audit firm to finish the audit work
- The lead audit firm has to make reference to the audit opinions issued by the participating audit firm when issuing the consolidated audit report

14. Which of the following is **NOT** an option for the lead audit firm to assign audit responsibility?

- Assume audit responsibility for the whole audit engagement
- Divide audit responsibility with the participating audit firm
- Do not take any audit responsibility at all

15. When the lead audit firm decides to assume audit responsibility for the whole audit engagement, the lead audit firm

- Should make reference to the audit of the participating audit firm in the audit report
- Should not make reference to the audit of the participating audit firm in the audit report
- Cannot issue an audit report

16. When the lead audit firm divides audit responsibility with the participating audit firm, the lead audit firm

- Should make reference to the audit of the participating audit firm in the audit report
- Should not make reference to the audit of the participating audit firm in the audit report

- Cannot issue an audit report

Audit partner identity

- For each audit engagement, the audit firm will assign an **audit partner** and some audit staff to conduct the audit work.
- After finishing all necessary audit procedures, the audit firm will issue an audit report; the audit partner usually signs the audit report on behalf of the audit firm (i.e., **signing the audit report in the name of the audit firm**).
- There is a long-running debate as to whether auditing standards should require the audit partner to **sign the audit report in personal name, in addition to the name of the audit firm**. Many commenters oppose to this requirement and suggest that auditing standards should permit the audit partner to **sign the audit report in the audit firm's name only**.

Review Questions

17. The auditing standards initially mandate that the audit partner should sign the audit report in
- Audit firm's name
 - Audit partner's personal name
 - Audit client's name
18. Many commenters oppose to the requirement of audit partner signing audit report in personal name and suggest that the audit partner signs audit report in
- Audit firm's name only
 - Audit partner's personal name only
 - Audit client's name only

CASE INFORMATION

Information about the audit of Main Inc. and Sub Inc.

Main Inc. is a large producer of gravel and cement. Most of Main Inc.'s products are sold to contractors, city, and state road departments. **Main Inc. has a wholly-owned subsidiary Sub Inc.** Sub Inc. has a special production line that produces customized gravel and cement for specific needs, like dams or military usage.

Main Inc. has paid **M LLP** to audit its financial statements for the last twenty-four years.

Sub Inc., the subsidiary of Main Inc., has special customers and its products specifications vary based on specific customers, so M LLP asks **S LLP** for auditing Sub Inc. because S LLP has audited Sub Inc. for fifteen years and thus is familiar with Sub Inc.'s customers and products.

In this case, M LLP is the lead audit firm located in New York and S LLP is the participating audit firm located in Chicago.

In the end, M LLP combines its own audit work and S LLP's audit opinion about Sub Inc. to issue the consolidated audit report. M LLP issued an **unqualified (clean) opinion** on Main Inc.'s 2015 consolidated financial statements, and S LLP issued an **unqualified (clean) opinion** on financial statements of Sub Inc., Main Inc.'s subsidiary. Financial statements of Sub Inc. reflect total assets constituting 10 percent of Main Inc.'s consolidated assets as of December 31, 2015, and total revenues constituting 12 percent of Main Inc.'s consolidated revenues for the year ended December 31, 2015. **M LLP maintains a moderate level of supervision over S LLP.**

[Manipulation: Dividing audit responsibility]

As suggested in the audit report, M LLP divided audit responsibility with S LLP in proportion to their relative participation in the audit engagement. S LLP was mainly responsible for auditing Sub Inc. and issuing the audit opinion about Sub Inc.'s financial statements; M LLP was mainly responsible for directly auditing Main Inc. and combining S LLP's audit opinion about Sub Inc. to issue the final audit report.

[Manipulation: Assuming audit responsibility]

As suggested in the audit report, M LLP assumed audit responsibility for the work performed by the S LLP. S LLP was mainly responsible for auditing Sub Inc. and issuing the audit opinion about Sub Inc.'s financial statements; M LLP was mainly responsible for directly auditing Main Inc. and combining S LLP's audit opinion about Sub Inc. to issue the final audit report.

[Manipulation: Signing audit report in firm's name]

The audit partner of M LLP, Michael Jones, signed the audit report in the name of the audit firm only.

[Manipulation: Signing audit report in personal name]

The audit partner of M LLP, Michael Jones, signed the audit report in his personal name, followed by the audit firm's name.

The following is the consolidated audit report issued by M LLP. M LLP is the lead audit firm that is responsible for auditing Main Inc., the holding company of Sub Inc.

Report of Independent Registered Public Accounting Firm

We have audited the accompanying consolidated balance sheets of Main Inc. and subsidiaries as of December 31, 2015, and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for the year ended December 31, 2015. These financial statements are the responsibility of Main Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

[Dividing audit responsibility] We did not audit the financial statements of Sub Inc., a wholly owned subsidiary, whose financial statements reflect total assets constituting 10 percent of consolidated assets as of December 31, 2015, and total revenues constituting 12 percent of consolidated revenues for the year ended December 31, 2015. Those financial statements were audited by S LLP whose report has been furnished to us, and our opinions, insofar as they relate to the amounts included for Sub Inc., are based solely on the report of S LLP.

[Assuming audit responsibility] No discussion.

We conduct our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

In our opinion, based on our audits and the report of S LLP, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Main Inc. and subsidiaries as of December 31, 2015, and the results of its operations and its cash flows for year ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

[Personal name] Michael Jones

[Firm's name] M LLP

New York, New York

The following is the audit report of Sub Inc. issued by **S LLP**. S LLP is the participating audit firm that is responsible for auditing **Sub Inc., the subsidiary of Main Inc.**

Report of Independent Registered Public Accounting Firm

We have audited the balance sheets of Sub Inc. as of December 31, 2015, and the related statements of operations, stockholders' equity and cash flows for the year ended December 31, 2015. These financial statements are the responsibility of Sub Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conduct our audits in accordance with standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

In our opinion, the financial statements present fairly, in all material respects, the financial position of Sub Inc. at December 31, 2015, and the results of its operations and its cash flows for year ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

S LLP

Chicago, Illinois

March 29, 2016

Review Questions

19. Which of the following arguments is true?

- M LLP is the participating audit firm that will issue the final audit report
- M LLP is the lead audit firm that directly audits the holding company Main Inc.
- S LLP is the participating audit firm that will issue the final audit report
- S LLP is the lead audit firm that directly audits the subsidiary Sub Inc.

20. Which of the following is true?

- Main Inc. is the subsidiary and audited by M LLP
- Sub Inc. is the subsidiary and audited by M LLP
- Main Inc. is the holding company and audited by M LLP; Sub Inc. is the subsidiary and audited by S LLP

21. What are audit opinions?

- M LLP issued qualified “unclean” opinion about Main Inc. and S LLP issued unqualified “clean” opinion about Sub Inc.
- M LLP issued unqualified “clean” opinion about Main Inc. and S LLP issued qualified “unclean” opinion about Sub Inc.
- Both M LLP and S LLP issued unqualified “clean” opinions

22. How does the lead audit firm assign audit responsibility?

- M LLP assumes full audit responsibility for the whole audit engagement, including taking the responsibility of the work performed by S LLP on Sub Inc.
- M LLP divides audit responsibility with the participating audit firm S LLP
- M LLP disclaims audit responsibility of audit work on Main Inc.

23. The consolidated audit report was signed in the

- Audit firm’s name only
- Audit partner’s personal name, followed by the audit firm’s name
- Audit client’s name

Misstatement

After the audit was completed, Main Inc. encountered some financial difficulty and eventually failed to pay off its debts. An SEC (the U.S. Securities and Exchange Commission) investigation indicated that Main Inc.'s financial statements were materially misstated.

[Audit failure in the holding company]

At the end of their investigation, the SEC concluded that **Main Inc. (Not Sub Inc.)** understated their **environmental restoration liability** by \$8 million, which resulted in an \$8 million overstatement of net income. This misstatement made Main Inc. appear to be financially secure when in fact Main Inc. was in danger of violating debt covenants.

[Audit failure in the subsidiary company]

At the end of their investigation, the SEC concluded that **Sub Inc. (Not Main Inc.)** understated their **environmental restoration liability** by \$8 million, which resulted in an \$8 million overstatement of net income. Although Main Inc. did not understate its liability directly, Main Inc. had to issue its consolidated financial statements by combining Sub Inc.'s financial statements. This misstatement of Sub Inc. made Main Inc. appear to be financially secure when in fact Main Inc. was in danger of violating debt covenants.

As a result of Main Inc.'s eventual insolvency (failure to pay off its debts), **Bierhoff Inc.**, a lender who loaned Main Inc. \$10 million, had to settle for collecting only \$1 million of its \$10 million loans, and thus **lost \$9 million**. Due to this financial loss, Bierhoff Inc. was forced to lay off 4 full-time employees. Bierhoff Inc. alleged that it relied on Main Inc.'s audited financial statements when deciding whether to loan Main Inc. the \$10 million. Furthermore, Bierhoff alleged that if M LLP had not incorrectly issued an unqualified (clean) opinion for Main Inc.'s financial statements, they (Bierhoff Inc.) would have never given the loan to Main Inc. Based on this assertion, Bierhoff Inc. is suing M LLP for \$9 million.

Review Questions

24. How much money did Bierhoff Inc. lose because of their reliance on Main Inc.'s materially misstated financial statements?
- \$150,000
 - \$5,000,000
 - \$9,000,000
25. What specific fraud did Main Inc. commit in order to overstate net income by \$8,000,000?
- Main Inc. understated the amount of federal income tax they owed
 - Main Inc. understated the environmental restoration liability
 - Main Inc. did not tell the auditors about a lawsuit that was pending in which Main Inc. was being sued for \$8,000,000

relating to a concrete bridge that collapsed, which was made using Main Inc. materials.

26. Which company understated its environmental restoration liability?
- Main Inc.
 - Sub Inc.
27. Which audit firm directly audited the financial statements that include misstated financial information?
- M LLP
 - S LLP

The following is a transcript taken from the civil negligence trial of M LLP and S LLP relating to their audits of Main Inc. and Sub Inc. After reading the case, you will be asked to make several judgments regarding the trial.

Bierhoff, Inc. v. M LLP

Summary, Case #952AI

Complaint: The plaintiff, Bierhoff, Inc., alleges that the defendant, M LLP, was negligent in performing its audit of the 2015 consolidated financial statements of Main Inc. and Sub Inc.

Answer: The defendant, M LLP, responds that it complied with auditing standards and therefore was not negligent.

Plaintiff Opening Statement: This case is about auditor negligence. You are about to find out what can happen when auditors do not do their jobs properly and serious fraud causes errors in the financial statements. My client, Bierhoff, Inc., relied on the financial statements of Main Inc., and later found out that the financial statements of Main Inc. were fraudulent. M LLP's negligence cost Bierhoff, Inc. \$9,000,000.

M LLP reported that the 2015 financial statements of Main Inc. were not materially misstated. Because of M LLP's negligence, materially misstated financial statements were given to Bierhoff, Inc. Bierhoff, Inc. relied on the misstated financial statements when it loaned \$10,000,000 to Main Inc. Main

Inc.'s financial statements listed a liability relating to the restoration of their quarries that was \$8,000,000 too low.

M LLP failed to find this inaccuracy and the fraud behind it because they did not perform an audit of sufficient quality; that is, they did not exercise the same degree of care that other auditors in their position would have used. As a result of this loss due to financial misstatements, Bierhoff was forced to lay off 4 employees. Bierhoff, Inc. was not the only party to suffer from M LLP's negligence. The stockholders of Main Inc. suffered large losses when the company cannot pay off its debts. Some business closed and all 87 Main Inc. employees lost their jobs. Because of the terrible job market, many of them are still unemployed now, and others had to accept far less attractive jobs.

I will prove my case by calling an expert witness, Ms. Evans, a respected former partner with a large accounting firm. Her expert testimony will point out why the performance of M LLP was substandard and will describe how such substandard procedures led to the misstatement of Main Inc.'s financial statements, which led to my client's losses. Ms. Evans will argue that M LLP should have known that the 2015 financial statements of Main Inc. were misstated and should have performed additional work to discover the precise nature of the misstatement.

Review Questions

28. The plaintiff argues that M LLP was negligent.

- ☐ True
- ☐ False

29. The plaintiff believes that M LLP should have detected the misstatement in Main Inc.'s financial statements.

- ☐ True
- ☐ False

30. Does Bierhoff, Inc. lose \$9,000,000 because of misstated financial statements?

- ☐ Yes
- ☐ No

Defense Opening Statement: It is our position that M LLP complied with generally accepted auditing standards in its audit of Main Inc.'s financial

statements, and that M LLP was not negligent. The plaintiff has alleged that M LLP was negligent in its audit of Main Inc.'s 2015 financial statements. Negligence can be established only when an auditor fails to exercise the usual judgment, care, skill, and diligence employed by other Certified Public Accountants (CPAs) in the community. CPAs use auditing standards to determine the type and amount of work they perform. It is the defendant's position that if an auditor complies with auditing standards, they have not been negligent.

The plaintiff must prove its allegations by a preponderance of the evidence. This means that it must show that the charges are more probably true than not true. The plaintiff cannot do so. I will present an expert witness, Ms. Brecht, a respected former partner with a large accounting firm, who will establish that M LLP made appropriate use of professional judgment in making its decisions, and that it in no way violated professional standards. It is Ms. Brecht's position that the fraud perpetrated by Main Inc. would not have been detected by other CPA's. In closing, M LLP is a competent, prudent accounting firm, and I am confident that you will find in its favor.

Review Questions

31. The defendant argues that M LLP was **NOT** negligent.

- ☐ True
- ☐ False

32. The defendant believes that M LLP complies with auditing standards and have done enough work to assure no misstatements.

- ☐ True
- ☐ False

Ms. Irene Evans, Expert Witness testifying for the Plaintiff: Main Inc. understated its environmental restoration liability by \$8,000,000, and M LLP failed to discover this misstatement. A proper audit would have revealed these irregularities, but M LLP did not perform a proper audit.

Main Inc. purposely understated its land restoration costs. Main Inc.'s management knew that the "lake method" of restoration would not be allowed for some quarries because they had tapped into a lead deposit during mining,

and the Environmental Protection Agency (EPA) had already determined that Main Inc. needed to use the “back-fill” method of restoration for that particular quarry. According to M LLP’s audit work papers, at the time of the audit, M LLP did not consider the possibility that Main Inc. could understate their environmental restoration liability by lying about the number of quarries that could be restored using the “lake method.” As a result, M LLP did not investigate this specific fraud risk. In my opinion, if M LLP has tested the soil and water from Main Inc.’s seven inactive quarries, they would have discovered the misstatement and prevented misstated financial statements from being distributed to unsuspecting investors and lenders.

Cross-examination

Questions from the defense- Ms. Evans, are there not countless ways in which fraud can be perpetrated and isn’t it impossible for auditors to identify and investigate every possible way in which a company’s financial statements could be misstated due to fraud.

Ms. Evans’ answer- Yes, that is true. However, the fraud that was perpetrated represented a significant fraud risk that M LLP should have identified and investigated.

Questions from the defense- Do auditing standards require auditors to have the soil and water from inactive quarries tested for the presence of hazardous materials to determine if the lake method of restoration can be used?

Ms. Evans’ answer- No, however auditing standards require auditors to be alert to the possibility of fraud.

Review Questions

33. Irene Evans believes that M LLP did not perform a proper audit.

- ☐ True
- ☐ False

34. According to Irene Evans, M LLP should have tested soils and water to determine if Main Inc. was committing fraud.

- ☐ True
- ☐ False

Ms. Joanne Brecht, Expert Witness testifying for the Defense: Auditing standards require auditors to perform a general investigation for unrecorded or understated liabilities, but neither auditing standards nor current practices require an auditor to have the soil and water from inactive quarries tested to determine if a mining company can use the lake method to restore its inactive quarries. Auditors use professional judgment to identify the areas of a company's financial statements that are at most risk for error and then concentrate their efforts on those high-risk areas.

M LLP performed Main Inc.'s audit for twenty-four years prior to the 2015 audit. In each of those years, Main Inc. restored all of their quarries by using the "lake method" without objection from the EPA. Furthermore, over the last twenty-five years, M LLP audited other similar mining companies who have also always used the "lake method" to restore their quarries without objection from the EPA. Mining companies almost always use the lake method to restore their inactive quarries, and it is extremely unlikely that other auditors would have anticipated that Main Inc. might not be allowed to use the lake method to restore one of its inactive quarries. Therefore, contrary to the plaintiffs' claim, other competent and prudent auditors would not have hired an environmental testing laboratory to test the soil and water from Main Inc.'s inactive quarries for the presence of hazardous materials. As a result, it is extremely unlikely that other competent and prudent auditors would have detected the fraud that occurred at Main Inc. Therefore, it is clear that M LLP's audit of Main Inc. was in full compliance with professional auditing standards.

Cross-examination:

Question from the plaintiff- Is this the first time the EPA has required a mining company to restore one of their quarries by filling it with dirt and planting grass & trees.

Ms. Brecht's answer- No, the EPA has previously required mining companies to restore their quarries by filling them with dirt and planting grass & trees. However, it is very uncommon.

Question from the plaintiff – Could M LLP have determined that Main Inc. would not be able to use the "lake method" to restore all of their quarries by testing the soil and water from all seven of Main Inc.'s inactive quarries?

Ms. Brecht's answer –Yes, I suppose that is correct.

35. What is Ms. Joanne Brecht's opinion about this case?

- M LLP complied with auditing standards and therefore is not responsible for the financial misstatement
- M LLP could have done the audit work better and prevents the financial misstatement

Plaintiff Closing Statement: The testimony you have heard today established that M LLP was negligent in its audit of the 2015 financial statements of Main Inc. A well-respected auditing practitioner, Ms. Evans, has told you that the procedures that M LLP used in evaluating the environmental restoration liability were substandard. The negligence of M LLP resulted in a \$9,000,000 loss for Bierhoff, Inc., and loss of jobs for 4 of Bierhoff Inc.'s employees and all 87 of Main Inc.'s employees. All of these innocent parties counted on M LLP to do its job, and M LLP failed them.

The most important errors made by M LLP were first, that it only had environmental testing performed for two of the seven quarries when a competent auditor would have tested all seven; second, that it relied on statements by Main Inc.'s management to determine which sites to test. Society expects more than that from auditors. We expect auditors to maintain an attitude of professional skepticism in dealing with their clients. We expect auditors to find \$8,000,000 irregularities and frauds such as the ones in Main Inc.'s financial statements. Why would we hire auditors if they were not able to find large irregularities in financial statements? M LLP did not live up to society's expectations, and it did not meet minimum auditing standards.

Defense Closing Statement: The plaintiff has told you that M LLP made some mistakes in its audit of the 2015 financial statements of Main Inc. It is your job to evaluate whether actions taken were actually mistakes.

In over twenty-five years of auditing mining companies, this is the only time that one of M LLP's clients was not allowed to use the "lake method" to restore one of their inactive quarries. Furthermore, our expert has testified that the EPA almost always allows mining companies to use the lake method to restore their inactive quarries. Therefore, it is extremely unlikely that other competent and prudent auditors put in this position would have detected the fraud that occurred at Main Inc. Thus, it is clear that M LLP was not negligent in its performance of Main Inc.'s 2015 financial statement audit.

Accordingly, I urge you to find in favor of the defendant, M LLP.

Review Question

36. The plaintiff argues that audit procedures M LLP used in evaluating environmental restoration liability are substandard and auditors should maintain an attitude of professional skepticism.

- ☐ True
- ☐ False

37. The defendant argues that, even if other auditors were put in this position, they would not have anticipated understatement of restoration liability because “lake method” has never objected by EPA before

- ☐ True
- ☐ False

Judge's Instructions to the Jury: It is your responsibility to determine the facts from the evidence presented to you. You will use these facts and the law given in these instructions to decide the case. You should consider the evidence in light of your own observations and experiences in life. You may draw any reasonable inferences from the proven facts. You must not, however, draw any inference from the number of witnesses who testified on one side or the other. In addition, keep in mind that statements made by attorneys are not evidence.

If you decide for the plaintiff on the question of liability, you must then determine the amount of money that will reasonably and fairly compensate Bierhoff Inc. for any of the following elements of damages proved by the evidence to have resulted from the negligence of M LLP.

- \$9 million dollars resulting from a failed loan to Main Inc.

Whether any of these elements of damages has been proved by the evidence is for you to determine.

Case Questions 1

1. Assume that you are a juror on this case, would you find that M LLP (i.e., the auditors) was negligent in their performance of Main Inc.'s audit?
 - Yes, M LLP was negligent
 - No, M LLP was not negligent
2. On a scale between 0 and 100, how probable is it that M LLP was negligent in their performance of Main Inc.'s audit (Where 0 = M LLP was certainly **not** negligent, 100 = M LLP was certainly negligent)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

3. **If you answered no for case question #1, you should answer 0 for this question.**

Imagine that you will be able to impose damages on M LLP to pay to compensate Bierhoff Inc. for its \$9 million loss. On the scale below, please indicate how much money, if any, you would be willing to require that M LLP pay Bierhoff Inc.? Remember that the principle of proportional liability applies- see the paragraph below

0.....\$1m.....\$2m.....\$3m.....\$4m.....\$5m.....\$6m.....\$7m.....\$8m.....\$9m

If a jury finds that the auditors were negligent, the jurors will then decide the amount of damages the auditors will be required to pay the plaintiffs. To make this determination, jurors first determine the amount of damages the plaintiffs incurred because of the misstated financial statements. Then, jurors consider the extent to which the auditors were responsible for the misstatement relative to other guilty parties such as the company's management. For example, assume that a jury in an auditor negligence lawsuit determined the plaintiffs lost \$10 million due to their reliance on materially misstated financial statements. Then, the jury judged that the company's management was 60% responsible and the auditors were 40% responsible for the misstated financial statements. The jury would require the auditors to pay the plaintiffs \$4 million (= \$10 million X 40%); or, if the jury determined that the auditors were 80% responsible, the auditors would be required to pay \$8 million, and so on. This method of determining the amount of damages auditors have to pay plaintiffs is referred to as proportional liability.

In this case, S LLP is the participating audit firm that is responsible for auditing Sub Inc., the subsidiary of Main Inc.

4. Would you find that S LLP was negligent in their performance of Sub Inc.'s audit?

- ☐ Yes, S LLP was negligent
- ☐ No, S LLP was not negligent

5. On a scale between 0 and 100, how probable is it that S LLP was negligent in their performance of Main Inc.'s audit (Where 0 = S LLP was certainly **not** negligent, 100 = S LLP was certainly negligent)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

6. **If you answered no for case question #1, you should answer 0 for this question.**

Imagine that you will be able to impose damages on S LLP to pay to compensate Bierhoff Inc. for its \$9 million loss. On the scale below, please indicate how much money, if any, you would be willing to require that S LLP pay Bierhoff Inc.?

0.....\$1m.....\$2m.....\$3m.....\$4m.....\$5m.....\$6m.....\$7m.....\$8m.....\$9m

7. What were your considerations when assessing whether or not **M LLP** was negligent in its performance of Main Inc.'s audit?

8. What were your considerations when assessing whether or not **S LLP** was negligent in its performance of Sub Inc.'s audit?

Case Questions 2

1. Please rate the extent to which you believe that auditors from M LLP intended to shirk responsibility for the audit of the subsidiary. (From 0 = Completely disagree to 100 = Completely agree)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90...
|.100

2. Please rate the extent to which you believe that auditors from M LLP felt accountable for the audit engagement. (From 0 = Not at all accountable to 100 = Completely accountable)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|.100

3. Please rate the extent to which you believe that auditors from M LLP were concerned about their reputations. (From 0 = Not at all concerned to 100 = Completely concerned)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|.100

4. Please rate the extent to which you believe that auditors from M LLP expended much effort on this audit engagement. (From 0 = Completely disagree to 100 = Completely agree)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|.100

5. Please rate the extent to which you believe that auditors from M LLP caused the audit failure. (From 0 = Not at all the cause to 100 = Completely the cause)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|.100

6. Please rate the extent to which you believe that auditors from M LLP could foresee the misstatement of environmental restoration liability prior to issuing an unqualified opinion. (From 0 = Not at all foreseeable to 100 = Completely foreseeable)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

7. Please rate the extent to which you believe that auditors from M LLP intended to conduct a high-quality audit. (From 0 = Not at all intended to 100 = Completely intended)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

8. Please rate the extent to which you believe that auditors from M LLP could have taken actions differently, which would have allowed them to detect the financial misstatement. (From 0 = Completely disagree to 100 = Completely agree)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

9. Please rate the extent to which you believe that auditors from M LLP are competent at auditing Main Inc. (From 0 = Not at all competent to 100 = Very competent)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

10. Please rate the extent to which you believe that auditors from M LLP are trustworthy. (From 0 = Not at all trustworthy to 100 = Very trustworthy)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....90....|....100

11. Please rate the extent to which you experience negative feelings towards M LLP in this case? (From 0 = No negative feelings to 100 = Very strong negative feelings)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

12. Please rate the extent to which you experience positive feelings towards M LLP in this case? (From 0 = No positive feelings to 100 = Very strong positive feelings)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

13. Please rate the extent to which you believe that auditors from S LLP caused the audit failure. (From 0 = Not at all the cause to 100 = Completely the cause)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

14. Please rate the extent to which you believe that auditors from S LLP could foresee the misstatement of environmental restoration liability prior to issuing an unqualified opinion. (From 0 = Not at all foreseeable to 100 = Completely foreseeable)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

15. Please rate the extent to which you believe that auditors from S LLP intended to conduct a high-quality audit. (From 0 = Not at all intended to 100 = Completely intended)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

16. Please rate the extent to which you believe that auditors from S LLP are competent at auditing Main Inc. (From 0 = Not at all competent to 100 = Very competent)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

17. Please rate the extent to which you believe that auditors from S LLP are trustworthy. (From 0 = Not at all trustworthy to 100 = Very trustworthy)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

18. Please rate the extent to which you experience negative feelings towards S LLP in this case? (From 0 = No negative feelings to 100 = Very strong negative feelings)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

19. Please rate the extent to which you you experience positive feelings towards S LLP in this case? (From 0 = No positive feelings to 100 = Very strong positive feelings)

0....|....10....|....20....|....30....|....40....|....50....|....60....|....70....|....80....|....
90....|....100

Wrap-up questions

Please answer the following questions about yourself. All responses will be strictly confidential.

1. What is your gender?
 - ☐ Male
 - ☐ Female
2. What is your age?
()
3. What is the highest level of education you have completed?
 - ☐ Some High School
 - ☐ High School Graduate
 - ☐ Trade or Professional School Graduate
 - ☐ Some College
 - ☐ Associate's Degree
 - ☐ Bachelor's Degree
 - ☐ Some Graduate School
 - ☐ Completed Graduate School
4. If you studied beyond high school, what was your area of concentration?
()
5. What is your current employment status?
 - ☐ Full-time employment
 - ☐ Part-time employment
 - ☐ Self-employed
 - ☐ Full-time student
 - ☐ Retired
 - ☐ Not currently employed, but looking for work
 - ☐ Not currently employed and not looking for work
6. What industry do you work in?
()
7. Have you ever worked for an organization that deals with environmental issues, restoration, or testing?
 - ☐ Yes
 - ☐ No
8. What is your approximate annual gross family income?
()