

Jury Verdicts Against Auditors under Precise and Imprecise Accounting Standards

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ABSTRACT

U.S. auditors are concerned that the greater imprecision in accounting standards under IFRS will lead to increased legal liability. We conduct an experiment with 749 mock jurors to examine how juries evaluate auditor conduct under precise and imprecise standards. We find that juries return *more* verdicts against auditors under imprecise standards – but only when the audit client’s accounting is conservative and deviates from industry norms. These negative consequences are eliminated when the conservative accounting is instead consistent with industry norms, suggesting that auditors should be able to anticipate and avoid increased legal exposure under imprecise standards. We also find that when the audit client’s accounting is aggressive, jurors return *fewer* verdicts against auditors under imprecise standards than precise standards. Taken together, our results suggest that imprecise standards are a double-edged sword that increases verdicts against auditors in some circumstances and decreases verdicts against auditors in other circumstances.

Key Words: audit litigation; principles v. rules; jury decision making; IFRS

I. INTRODUCTION

A recent SEC proposal allowed some U.S. firms to begin preparing their financial statements in accordance with International Financial Reporting Standards (IFRS) in 2009 and requires all U.S. registrants to adopt IFRS by 2016. IFRS tend to provide less precise guidance than current U.S. accounting standards (Gill 2007; Forgeas 2008; Bratton and Cunningham 2009; Nelson 2003) so their application requires more professional judgment. The increase in professional judgment required under less precise accounting standards may have implications for the incidence and success of legal challenges against auditors (Hail et al. 2009). Indeed, auditors have expressed concern that the adoption of IFRS will result in more second-guessing of accounting estimates and great legal liability (Johnson 2008; Chasan 2008; DiPiazza et al. 2008a; DiPiazza et al. 2008b; Barlow 2009) and have used these concerns to argue for statutory caps on auditor liability (Levitt and Nicolaisen 2008). Despite the importance of understanding the litigation-related costs of adopting less precise accounting standards, there is little empirical evidence about the effects of accounting standard precision on jury verdicts against auditors. Our study helps to fill this void.

We conduct an experiment in which 749 mock jurors deliberate in 130 six-person juries to determine an audit firm's liability in a negligence lawsuit. In the lawsuit, the auditor is sued for negligence by a large investor of one of its audit clients. The audit client is now bankrupt, and the investor alleges that the audit firm erred by allowing its client to recognize revenue before it was earned. The experiment has a 2 X 2 X 2 between-participants design. We manipulate the audit client's reporting choice (Client Reporting: Aggressive, Conservative), the level of precision in the revenue recognition standard (Standard Precision: Precise, Imprecise), and whether the audit client's reporting choice is consistent with industry norms (Accounting Norms: Consistent, Inconsistent).

Auditors are concerned that juries will return more verdicts against auditors under imprecise accounting standards (Johnson 2008; Chasan 2008; DiPiazza et al. 2008a; DiPiazza et al. 2008b; Barlow 2009). We concur that this is one possibility; jurors may return *more* verdicts against auditors under imprecise standards because it is more difficult for auditors to point to rules that expressly justify their client's financial reporting decisions.¹ However, this is not the only possibility. It is also possible that juries will believe that imprecise standards justify and support a broader range of reporting choices and thus return *fewer* verdicts against auditors. A third possibility is that changing the precision of accounting standards will have *no impact* on verdicts because most states' negligence standards suggest that jurors' primary consideration should be whether the client's reporting is consistent with norms rather than whether the client's reporting is consistent with accounting standards.

Our experimental results show that the effect of accounting standard precision on jury verdicts depends on both the client's reporting choice and whether the accounting is consistent with industry norms. Contrary to auditors' expectations, we find that when the client's accounting is aggressive, juries view auditor conduct more negatively under a precise standard than an imprecise standard. If the client violates a precise standard, a majority of juries return verdicts against the auditor. However, this same reporting choice is viewed less negatively by jurors when the accounting standard is imprecise — a majority of juries return verdicts in favor of the auditor under the imprecise standard.

These results suggest that the flexibility afforded by imprecise standards can work in auditors' favor. The vast majority of our mock jurors should have questioned the auditors' judgment for allowing the client's aggressive reporting choice, because more than 85% of similar pre-test participants believed that the client's accounting was unacceptable. Yet, only 0% (38%) of

¹ In explaining the highly detailed nature of U.S. GAAP, Zeff (1995) notes "auditors, as a defense in potential lawsuits, want to be able to cite *express provisions* of GAAP in support of their clients' financial reporting" (emphasis added).

juries find against the auditor under the imprecise standard when the accounting is consistent (inconsistent) with industry norms. Our results suggest that imprecise standards make it harder for jurors to justify punishing auditors for allowing aggressive reporting.

The above results seem to indicate that auditors need not be concerned about greater legal liability under imprecise accounting standards. However, when the client's accounting is conservative rather than aggressive, we find that standard precision has an opposite effect on verdicts. Under conservative accounting, juries return *more* verdicts against the auditor under an imprecise standard than a precise standard. Importantly, however, this relation holds only when the audit client's reporting differs from industry norms. No juries in our experiment find against the auditor when the accounting is conservative and consistent with industry norms, regardless of whether the standard is precise or imprecise. However, when the conservative accounting choice deviates from industry norms, significantly more juries find against the auditor under the imprecise standard (38%) than the precise standard (7%). Our results are consistent with the idea that jurors make use of a hierarchy of decision rules: when jurors do not have the clear decision rule provided by a precise standard, they seek other clear decision rules such as whether the client's accounting is consistent with that of other firms.

Taken together, our results indicate that imprecise standards are a double-edged sword in terms of auditor liability. When the client's reporting choice is aggressive, the same reporting results in *less* perceived auditor culpability under an imprecise standard. However, when the client's reporting choice is conservative, the same reporting results in *more* perceived auditor culpability under an imprecise standard, though only if the reporting deviates from industry norms.

Our results also suggest that the aggressiveness of the client's reporting choice is a better predictor of verdicts under precise standards than imprecise standards. Indeed, the reporting choice matters surprisingly little to jurors under imprecise standards. Approximately 15% (85%) of pre-

test jurors viewed the accounting as acceptable in our Aggressive (Conservative) reporting conditions, yet the aggressiveness of the client's reporting does not predict verdicts against auditors in the imprecise conditions. Instead, jurors in the imprecise conditions appear to focus solely on whether the audit client's reporting is consistent with that of other firms. The increased importance of consistency with norms under imprecise standards indicates that audit firms will be highly motivated to develop and follow reporting norms. If litigation concerns lead auditors to herd in their application of imprecise standards, this will defeat one of the primary purposes of less precise, principles-based accounting standards – to allow firms more flexibility to communicate their underlying economic transactions. On the other hand, it also will reduce concerns about decreased comparability of financial reports under imprecise standards. We anticipate that auditors will be hesitant to allow their clients much flexibility in reporting if they are worried about increased legal exposure.

We hope that our results inform auditors and regulators as they prepare for the adoption of IFRS. The SEC has provided a roadmap for IFRS adoption, but has deferred a final decision on mandatory adoption of IFRS until 2011. This delay provides additional time for the accumulation of evidence to help auditors and regulators analyze and prepare for potential issues related to IFRS adoption, such as increases in legal liability. Our results suggest that, for the most part, verdicts against auditors will not increase under imprecise standards. In fact, imprecise standards will result in fewer verdicts against auditors under some conditions. However, we identify one condition in which auditors' legal exposure may increase: when the client's accounting is conservative but deviates from industry norms. Importantly, this increase in potential legal liability can be avoided. When the same accounting is consistent with industry norms, we observe no increased liability under imprecise standards. Thus, it appears that consistency with norms can provide the same safe

harbor as consistency with a precise standard. In other words, any increased legal exposure under imprecise standards can be anticipated (and avoided), as long as there are reporting norms.

In addition to the practical implications of our study to auditors and regulators, our results make several contributions to the academic literature. To our knowledge, Becker et al. (2009) is the sole existing study that examines how standard precision influences juror decisions about auditor liability.² Becker et al. examine the effects of standard precision on verdicts in a scenario in which the client's accounting is conservative and there are no accounting norms. They find that jurors are more likely to find the auditor culpable under imprecise standards and conclude that imprecise standards will result in more legal exposure for auditors. Our study extends Becker et al. (2009) and arrives at different, more complex conclusions regarding the litigation consequences of imprecise standards. Further, our paper is the first to examine the role of accounting norms on jury verdicts against auditors and to provide the insight that norms will take on enhanced importance in determining legal exposure under imprecise standards.

Finally, our paper contributes to the general academic literature on jury decision making. A growing body of jury literature in other domains suggests that juries evaluate defendants who violate industry norms negatively, even when those norms are not mandated by laws or professional standards (e.g., Prentice and Koehler 2003). However, it is not clear from these studies whether norms operate as a general main effect in liability suits or in a more complex fashion. We offer a theory of liability judgments that supports the latter claim. Specifically, we predict and find that rule precision and norms have interactive effects on jury verdicts.

² Donelson et al. (2010) examine the effects of standard precision on the incidence and outcomes of federal class action lawsuits against reporting firms. However, their study does not examine the effects of litigation against audit firms.

II. BACKGROUND & THEORETICAL DEVELOPMENT

Background

Traditionally, U.S. firms' financial statements have been prepared in accordance with U.S. GAAP. However, there is an international movement away from use of country-specific accounting standards and towards use of a single set of standards determined by an international standard setting body. Many countries already require the use of international financial reporting standards (IFRS), and the SEC recently laid out a roadmap for U.S. firms' adoption of IFRS. Under this roadmap, some U.S. firms were allowed to adopt IFRS beginning in 2009, and all U.S. firms will use IFRS by 2016 (SEC 2008).

Both international and U.S. accounting standards were developed based on underlying conceptual frameworks and thus are "principles-based" (Nelson 2003; Schipper 2003). However, U.S. GAAP is generally thought to be more "rules-based" than IFRS. Nelson (2003) defines "rules" broadly to include specific criteria, "bright-line" thresholds, examples, scope restrictions, exceptions, subsequent precedents, and implementation guidance. These items tend to increase the precision of accounting standards and therefore reduce uncertainty regarding how transactions should be reflected in the financial statements.

Prior studies have examined the effects of accounting standard precision on preparer (Psaros and Trotman 2004, Agoglia et al. 2010) and auditor behavior (Trompeter 1994, Hackenbrack and Nelson 1996, Gibbins et al. 2001, Nelson et al. 2002, Kadous et al. 2003, Ng and Tan 2003, Segovia et al. 2009). In this study, we focus on how the level of precision in accounting standards affects *jury verdicts* in auditor negligence lawsuits.³ There is uncertainty regarding how decreasing

³ Jury judgments are critical in determining auditor liability. Although the majority of cases do not go to trial, auditors and plaintiffs consider expected trial outcomes in making decisions about settlements. Alexander (1991) argues that the failure of overly risk-averse defendants, along with structural factors, threaten the link between expected jury outcomes and settlement amounts in many securities suits; however, she notes that accountants, who are repeat players, are likely to be less willing to settle non-meritorious suits than other defendants, and so the link will be stronger for them than other defendants.

precision in accounting standards will affect auditors' litigation environment (Hail et al. 2009) due to the paucity of research in this area. Our study sheds light on this important issue.

How Do Juries Determine Auditor Liability under Precise and Imprecise Standards?

Auditors attest to whether a firm's financial statements fairly present its financial position, results of operations, and cash flows in accordance with generally accepted accounting principles. Auditors' liability to third parties generally arises when they provide clean audit opinions on financial statements that are subsequently alleged to have been misstated due to negligence or fraud. It is generally difficult to prove fraud against auditors because proof of intent to deceive or reckless behavior is required. Consequently, most litigation against auditors alleges negligence rather than fraud (Causey and Causey 1991).⁴

The details of negligence laws vary by state (Whittington and Pany 2010). However, in most states, whether the auditor exercised reasonable care and competence is assessed relative to the levels that other professionals in the field would apply in the same situation (Causey and Causey 1991).⁵ For example, Illinois jurors (Illinois Pattern Jury Instructions, 2006) are instructed that *'professional negligence' by an auditor is the failure to do something that a reasonably careful auditor practicing in the same or similar localities would do, or the doing of something that a reasonably careful auditor would not do, under circumstances similar to those shown by the evidence.* Similarly, Florida jurors (Florida Standard Jury Instructions—Civil Cases, 2000) are told: *Negligence is the failure to use reasonable care. Reasonable care on the part of an auditor is the care that a reasonably careful auditor would use under like circumstances.* These instructions suggest that an auditor should be judged negligent if he failed to perform an audit procedure that a

⁴ In both cases, the legal standard of proof is subjective (e.g., Kadous 2000; Ball 2009).

⁵ The plaintiff must prove several elements of its case against the auditor, but the difficult factual issues that arise (and that juries are asked to resolve) are typically whether the financial reports are materially misstated and whether the auditor exercised reasonable care and competence. Other elements include whether the information was provided in the ordinary course of the auditor's business, whether the plaintiff suffered a loss, and whether the plaintiff's reliance on the information was warranted; the first two are typically easy to provide and the third is handled differently in different jurisdictions. See Feinman (2007, 174-175).

reasonably careful auditor would perform or if the auditor failed to constrain the client's reporting in a way that a reasonably careful auditor would.

If we apply this standard of proof to a case in which a plaintiff alleges that an audit firm is negligent for allowing a particular treatment, jurors should find the auditor negligent if other auditors would not allow this treatment under the same circumstances. How will jurors determine whether other auditors would have allowed this treatment? A primary consideration will likely be whether the same accounting treatment is currently used by similar companies with different auditors. In other words, a strict reading of this type of negligence standard suggests that verdicts will be based on whether the client's accounting is consistent with accounting norms.⁶

There is no existing research that specifically examines the role of accounting norms on verdicts against auditors. However, research in other domains suggests that norms affect jurors' negligence assessments. Prentice and Koehler (2003) demonstrate the influence of norms on juror judgments in two scenarios – medical malpractice and malpractice by financial advisors. They find that mock juries are fifty percent more likely to find a doctor negligent when the doctor used an unconventional treatment protocol than when the treatment was conventional, despite the fact that, in both cases, the deceased patient would have lived had a different treatment protocol been used. They show similar effects when a financial advisor invests his client's money either in widely owned conventional stocks or less widely owned unconventional stocks.

These studies suggest that accounting norms will be the primary determinant of jury verdicts in cases that allege auditors were negligent in allowing a particular accounting treatment. However, auditor negligence cases have an important element that is missing from many other types of

⁶ Plaintiffs may allege auditor negligence based on other aspects of auditor behavior, such as failing to discover a client fraud or failing to perform a specific audit procedure. These sorts of allegations are no more or less likely under precise versus imprecise accounting standards, and so are not central to the debate about how a change in standard precision will impact auditor liability. We focus on auditors' willingness to allow an accounting treatment because choice of treatment is constrained by more precise standards.

professional negligence cases. Unlike doctors or lawyers, auditors have official standards (i.e., accounting standards) informing their professional judgments. If an audit client's financial statements comply with accounting standards, this does not guarantee that statements are fairly presented or conclusively establish a lack of auditor negligence, but it is persuasive evidence of fair presentation (Ball 2009) and is a common defense against negligence (Causey and Causey 1991). Thus, it seems likely that consistency with accounting standards will affect jurors' judgments about auditor negligence. Indeed, some evidence suggests that if consistency with accounting norms and consistency with accounting standards are in conflict, consistency with standards will be a more important factor in jury verdicts. Specifically, Buckless and Peace (1993) find that jurors rely more heavily on auditing standards developed by an authoritative, external source (government) than those developed by auditors themselves. Accounting standards are generally authoritative and external to the client firm and its auditor, so applying Buckless and Peace's results to our setting suggests that accounting standards may be more important than accounting norms in jurors' minds.

Using an experiment, we are able to examine the relative roles of norms and accounting standards in jury verdicts against auditors under precise standards similar to current U.S. GAAP. This is an important first step, because understanding the relative roles of these benchmarks is critical in helping us understand the potential effects of decreasing standard precision on jury verdicts. In many states, the law instructs jurors to determine whether an audit firm is negligent based on whether its conduct would be customary in the industry, suggesting that consistency with norms will be the primary determinant of verdicts against auditors. If jurors indeed use norms as the primary determinant of auditor negligence, then changing the precision of accounting standards

will have little effect on their verdicts, because consistency with standards was never an important factor.⁷

However, if consistency with accounting standards *does* play a significant role in jurors' negligence assessments, changing the precision of accounting standards will affect verdicts. We argue that jurors will consider consistency with accounting standards when assessing negligence. In fact, based on Buckless and Peace's (1993) results, we predict that consistency with standards will play a larger role in jury verdicts than consistency with norms. However, we only expect consistency with standards to play a large role when the accounting standard is precise. When the standard is instead imprecise, jurors will find it more difficult to identify whether the client's reporting violates the accounting standard.⁸ Potential jurors with significant accounting knowledge are unlikely to be selected as jurors in an auditor negligence case (Zeisel and Diamond 1976; Lilly 2001), and we expect non-expert jurors to look for clear, simple decision rules (Simon and Chase 1973). When the accounting standard is imprecise, juries cannot easily determine whether the client's financial reporting choice violates the accounting standard, so we expect them to instead rely on whether the accounting is consistent with norms.⁹

In sum, before we can predict the effect of less precise accounting standards on jury verdicts, we must understand the determinants of jury verdicts under precise standards. If jury verdicts under precise standards are primarily determined by whether the accounting treatment is customary (i.e., consistent with norms), then changes in standard precision should have little effect

⁷ It is possible that decreasing the precision of accounting standards will lead to more diffuse norms. However, it seems unlikely that accounting treatments will become so varied that norms cannot be identified.

⁸ In the *Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission* (Pozen 2008, 12), one of the four factors that the Committee identifies as important in determining the reasonableness of reporting under principles-based standards is "the degree to which a company's approach is consistent with current accounting practice." The other three factors mentioned by the Committee are "the available alternatives a company identified," "the robustness of a company's analysis of the relevant literature and review of the pertinent facts," and "how a company's conclusions meet investors' information needs."

⁹ If it is not clear whether the client's reporting treatment is consistent with accounting norms, we expect jurors to look for clear answers to other simple decision rules, such as whether the audit was conducted in accordance with GAAS (Buckless and Peace 1993) or whether the financial reporting choice and/or audit methodologies employed are consistent with firm policies or decision aids (Jennings et al. 1993, Lowe et al. 2002).

on verdicts, *ceteris paribus*. However, if as we expect, the primary determinant of jury verdicts under precise standards is whether the accounting violates the standard, then changing standard precision will affect verdicts because it eliminates this simple decision rule. In this case, norms will play an increasing role under imprecise standards.

III. EXPERIMENTAL METHOD

Participants

We tested these ideas in an experiment in which 749 undergraduate students participated in 130 deliberating juries. Participants were enrolled in an introductory accounting course at a large state university. Classroom instructors had not covered the accounting standards applicable to the experimental case prior to the study. Participants' lack of prior knowledge about the relevant accounting standards puts them on comparable footing with jurors in a real auditor negligence trial, because potential jurors with significant accounting knowledge would likely be eliminated during *voir dire* (Zeisel and Diamond 1976; Lilly 2001). Participants' lack of specific knowledge about the relevant accounting standards also allows us to manipulate the precision of the accounting standard without creating unrealistic conditions.

Of the 749 study participants, 63% were male and 99% were single. Their mean age was 20. Participants indicated their political beliefs on a 7-point scale with endpoints labeled "Extremely Liberal" (1) and "Extremely Conservative" (7). Participants indicated diverse political views, with 34% indicating liberal beliefs (rating less than 4), 39% indicating conservative beliefs (rating greater than 4), and 27% indicating neutral beliefs (rating equal to 4). To sit on a jury in the U.S., a person must be at least 18 years old, a U.S. citizen, and not have been convicted of a felony. Seven percent of participants indicated that they did not meet at least one of these conditions.

Materials and Design

Our experiment has a 2 X 2 X 2 between-participants design. We manipulated the audit client's reporting choice (Client Reporting: Aggressive, Conservative),¹⁰ the precision of the accounting guidance (Standard Precision: Precise, Imprecise) and whether the audit client's financial reporting is consistent with industry accounting norms (Accounting Norms: Consistent, Inconsistent). Participants acted as jurors in an auditor negligence case. A large investor in the audit client had sued the audit firm, alleging that the audit firm provided an unqualified audit opinion on financial statements that were materially misstated. The key issue in the lawsuit concerns the appropriateness of the client's revenue recognition policies. The client is a commercial real estate development company, and, prior to its recent bankruptcy, it recognized revenue for properties sold at the time of closing. The client required buyers to make a down payment at closing, with the remaining amount to be paid to the developer over the following thirty years. The required down payment before recognizing revenue was 9% of the property price in the Aggressive Reporting condition and 31% in the Conservative Reporting condition.

The case materials informed participants that SFAS No. 66 addresses when profits from sales of commercial real estate can be recognized. Specifically, SFAS 66 states that the seller can recognize revenue only if the collectability of the sales price is reasonably assured. The materials stated that, according to SFAS 66, this condition is met "*if the buyer's down payment is large enough to demonstrate the buyer's commitment to pay for the entire property (i.e., large enough that the buyer will not later walk away from the deal).*" Participants in the Imprecise Standard condition did not receive additional information to help them determine the size of down payment required to signal a buyer's "commitment to pay." Participants in the Precise Standard condition were told, "*SFAS No. 66 further states that this condition is met if the down payment is at least 20%*

¹⁰ We are interested in the relative level of aggressiveness in the client's accounting treatment, rather than the absolute level. However, we use the terms 'Aggressive' and 'Conservative' for ease of exposition.

of the sales price.”¹¹ We also manipulated whether the down payment that the client firm required before recognizing revenue was consistent with industry accounting norms. Participants in the Consistent (Inconsistent) Norms condition were told, “*most other firms in the industry require an equal-sized (larger) down payment before recording profits on their commercial real estate sales.*”

We selected the percentages used in the case materials (9%, 31% and 20%) based on the results of a pre-test with 152 participants who have similar demographics as the Study 1 participants.¹² We described SFAS 66 to pre-test participants by providing them with the first italicized SFAS 66 passage above (i.e., *if the buyer’s...*). We told participants that a commercial real estate development firm is trying to figure out the minimum down payment amount that provides reasonable assurance that the buyer is committed to pay for the entire property. Pre-test participants indicated that the initial down payment would need to be “at least ___% of the total sales price to provide reasonable assurance of the buyer’s commitment to pay.”

The median response to this question was 20%.¹³ Consequently, we informed participants in the Precise Standard conditions that SFAS 66 specified a minimum 20% down payment before revenue recognition. On average, this precise threshold is interpreted the same as the less precise wording in the alternative condition, providing some assurance of consistency of interpretation across the Imprecise Standard and Precise Standard conditions in Study 1.¹⁴

¹¹ In reality, SFAS 66, *Accounting for Sales of Real Estate*, is a precise standard, providing bright line down payment percentages that generally provide reasonable assurance of a commitment to pay. The percentages differ based on asset type, ranging from 5% for single-family primary residences to 25% for commercial property with deficient cash flows. Our participants’ lack of prior knowledge about the standard allows us to create a Precise Standard condition with a bright line threshold and an equally plausible Imprecise Standard condition with no threshold.

¹² Pre-test participants were drawn from an introductory accounting class at the same university. There is no overlap between the two samples. Pre-test participants’ mean age is 20 years. Fifty-eight percent of pre-test participants are male, 95% are jury-eligible, and 31% (40%) indicate liberal (conservative) political views.

¹³ This value was also the modal response. The mean of all responses was 20.2.

¹⁴ To our knowledge, Becker et al. (2009) is the only existing study that investigates the effects of standard precision on jurors’ assessments of auditor negligence. Becker et al. (2009) examine jurors’ assessments of auditor negligence under a precise and imprecise lease standard and conclude that jurors evaluate auditors more negatively under imprecise standards. However, Becker et al. (2009) acknowledge that the design of their study makes it difficult to draw strong inferences about the legal liability consequences of changing precision in accounting standards. In Becker et al. (2009)’s experiment, jurors evaluate auditor conduct in a negligence lawsuit. The auditor is alleged to have allowed a

To manipulate client reporting and to allow us to examine the validity of auditors' concerns about second-guessing, we set the client firm's required down payment at a level that most participants thought indicated a commitment to pay in the Conservative Reporting conditions and at a level that most participants thought failed to indicate a commitment to pay in the Aggressive Reporting conditions. The 85th percentile of responses to the pre-test question was 30% and the 15th percentile was 10%. Therefore, we set the down payment at 31% in the Conservative Reporting condition. This level is low enough to be realistic and high enough that firm management and the auditor should be relatively safe from future scrutiny because a significant majority of prospective jurors believes it to be adequate. Based on the pre-test, we would expect approximately 15% of participants to believe that the auditor is negligent for allowing revenue recognition with a 31% down payment. We set the down payment at 9% in the Aggressive Reporting condition. This is still a realistic level, but based on the pre-test, we would expect approximately 85% of participants to believe that the auditor is negligent for allowing revenue recognition with a 9% down payment.

Procedures. Participants completed the materials during discussion sections of a large introductory accounting course. Participation in the study was voluntary. Participants were randomly assigned to one of the eight experimental conditions and provided with a set of case materials. After reviewing the materials, participants provided a set of individual judgments about the case. Specifically, they assessed the appropriateness of the audit firm's actions, the audit quality, the audit firm's responsibility for the investor's losses, and provided an overall verdict. Participants then answered manipulation check and demographic questions.

client to inappropriately report lease transactions. Half the jurors are told that a lease must be capitalized if the lease term is "75% or more" of the economic life of the leased asset (precise standard), and the other half of jurors are told that a lease must be capitalized if the lease term covers "most" of the economic life of the asset (imprecise standard). The audit client does not capitalize a lease that covers 70% of the leased asset's life. We conducted a pre-test study (results not reported) and found that, on average, jurors interpreted "most" as 60% rather than 75%. Thus, when Becker et al. (2009) find that participants in the imprecise (i.e., "most") condition view the auditors' conduct more negatively than those in the precise (i.e., "75% or more") condition, it is possible that this result is driven not by differences in the standard precision across conditions but by the fact that a majority of participants in the imprecise condition believe the "most" threshold is met when a lease covers 70% of the asset's life.

After making their individual assessments, participants deliberated in juries of six participants in the same experimental condition. We used six-person juries because the U.S. Supreme Court ruled that this is a minimum allowable jury size (Williams v. Florida 1970). Our final sample includes 130 juries. After deliberation, each jury assessed the same set of dependent measures as the individual jurors. We informed juries that their job was to come up with a unanimous verdict, but juries were allowed to indicate that they could not come to a consensus (i.e., hung juries were allowed). After jury deliberation and assessments, jurors provided a second set of individual assessments.

Prior research indicates that the jury's ultimate verdict matches that of the majority of jurors on the first ballot over 90% of the time (Kalven and Zeisel 1966; Sandys and Dillehay 1995). Indeed, it is the norm in accounting and legal experimental research to use juror judgments rather than jury judgments in examining audit liability. However, prior research mapping jurors' pre-deliberation verdicts into jury verdicts was performed within the context of criminal cases rather than civil cases such as audit negligence cases. More importantly, auditor liability is ultimately determined by juries, rather than jurors. Consequently, our main tests employ jury judgments and decisions, although we report supplemental analysis of juror's pre-deliberation judgments to verify the congruency between individual juror and jury judgments.

IV. RESULTS

Preliminary analysis and manipulation checks

To verify that juries attended to our manipulation of the precision of the accounting standard, the post-experimental questionnaire asked each jury to indicate whether the relevant accounting standard specified a minimum down payment to demonstrate the buyer's commitment. Of the 118 juries responding to this question, 117 responded correctly. We also asked juries to fill in the down payment amount that was required by the standard, if there was a requirement. Of the

54 juries in the Precise Standard conditions, 53 indicated 20% and the remaining jury indicated 21%. These analyses indicate a successful manipulation of standard precision.

To verify that juries attended to our manipulation of the consistency of the client's financial reporting choice with norms, we asked them whether the company's accounting treatment was consistent with norms, inconsistent in that it required a larger down payment than other firms, or inconsistent in that it required a smaller down payment than other firms. Of the 118 juries responding to this question, 117 responded correctly, indicating a successful manipulation of norms. We use all available observations for each analysis in the results that follow. However, inferences are unchanged if we omit data from the 14 juries that either neglected to respond to a manipulation check item or failed a manipulation check. In addition, 13 of the 130 juries included fewer than six people. Inferences are also unchanged if we omit data from the smaller juries.¹⁵

Main tests for evaluations of auditor conduct

We predict that when juries evaluate auditor conduct and determine verdicts, they will rely primarily on whether the client's reporting meets the accounting standard when the standard is precise, but they will rely primarily on whether the client's accounting is consistent with norms when the standard is imprecise. We measure juries' evaluations of the auditor's conduct in two ways. We ask juries to assess (a) the appropriateness of the auditor's actions and (b) the quality of the audit work. Both measures are collected on 9-point scales, with higher values reflecting more positive views of auditor conduct. Cell means and standard deviations are provided in Panel A (appropriateness) and Panel B (audit quality) of Table 1 for Precise Standards and of Table 2 for

¹⁵ In both cases, the interaction of Standard Precision and Norms is somewhat weakened in the 2 x 2 x 2 MANOVA ($p = 0.10$ two-tailed when small juries are omitted and $p = 0.12$ two-tailed when juries that didn't complete or incorrectly answered the manipulation check questions are omitted); however, all inferences for separate analyses of effects under Precise Standards and Imprecise Standards are identical to those reported in the paper.

Imprecise Standards. The two measures are highly correlated ($r = 0.91$, $p < 0.01$), indicating that joint analysis of the two dependent measures is appropriate.

We begin our analysis by estimating a MANOVA model for these two measures. Results are provided in Table 3, Panel A. The model results confirm that standard precision interacts with both the aggressiveness of client reporting (Standard Precision by Client Reporting, $F_{2,121} = 10.54$, $p < 0.01$) and whether the norm is violated (Standard Precision by Norms, $F_{2,121} = 3.14$, $p = 0.05$), indicating that jury decisions depend on client reporting and norms to different extents under precise versus imprecise standards.

To examine whether the specific form of these interactions supports our predictions, we calculate a composite Auditor Conduct measure by taking the mean of each jury's two evaluations and graph this composite measure for Precise Standards and Imprecise Standards (see Figure 1, Panel A). We also conduct separate follow-up MANOVAs for the two levels of standard precision (see Table 3, Panels B and C). The Precise Standards MANOVA shows a significant main effect of Client Reporting ($F_{2,56} = 34.11$, $p < 0.01$), an insignificant main effect of Accounting Norms ($F_{2,56} = 1.24$, $p = 0.30$), and a marginally significant interaction term ($F_{2,56} = 3.02$, $p = 0.06$). The left-hand graph in Panel A of Figure 1 illustrates the nature of these effects. Evaluations of auditor conduct are uniformly high when the client's accounting is conservative and clearly complies with the precise standard. Auditor conduct is perceived to be lower when the client's reporting is aggressive and does not comply with the precise standard, especially when the reporting is inconsistent with industry reporting norms.

When standards are imprecise, the pattern of significance is very different. The Imprecise Standards MANOVA shows a significant main effect of Accounting Norms ($F_{2,64} = 12.30$, $p < 0.01$), an insignificant main effect of Client Reporting ($F_{2,64} = 1.31$, $p = 0.28$), and an insignificant interaction term ($F_{2,64} = 1.49$, $p = 0.23$). The right-hand graph in Panel A of Figure 1 shows that

under imprecise standards, juries judge auditor conduct more favorably when the client's reporting is consistent with industry norms than when the reporting violates industry norms.¹⁶

The above results suggest that standard precision affects how juries evaluate auditor conduct. We are able to directly compare jury perceptions of auditor conduct for identical client reporting decisions under precise and imprecise standards using planned contrasts. We use our composite Auditor Conduct measure and contrast each Precise Standards condition with the identical reporting condition under Imprecise Standards. When the client's reporting is Aggressive, juries evaluate auditor conduct more positively under imprecise standards than precise standards, both when the reporting is consistent with norms ($t_{27} = 3.90$, two-tailed $p < 0.01$) and when it deviates from norms ($t_{27} = 1.90$, two-tailed $p = 0.07$). When the client's accounting is instead Conservative, juries evaluate the auditor more negatively under the imprecise standard, but only when the reporting deviates from norms ($t_{19} = 1.31$, two-tailed $p = 0.07$). When the conservative accounting is consistent with norms, we observe no difference in perceived auditor conduct from juries in the Precise and Imprecise conditions ($t_{33} = 0.13$, two-tailed $p = 0.90$).¹⁷

Main tests for verdicts

In addition to assessing auditor conduct, juries chose a verdict either in favor of the plaintiff (against the auditor) or in favor of the auditor. The proportions of juries choosing each verdict are presented in Panel C of Tables 1 and 2, for Precise Standards and Imprecise Standards, respectively. We predict that jury verdicts will depend largely on whether client reporting complies with the standard when that standard is precise, but will depend primarily on consistency with norms when the standard is imprecise. Table 4, Panel A, presents a general linear model with a logit link. This model is appropriate for testing hypotheses with binary dependent measures as it assumes a

¹⁶ The patterns of inferences described for the composite measure also hold for each measure, individually.

¹⁷ We test for equality of variances across conditions before conducting the planned contrasts. We observe unequal variances for the first three contrasts, and thus we apply the Satterthwaite adjustment when calculating the t-statistics for these contrasts.

binomial error distribution.¹⁸ Consistent with our findings for auditor conduct, we find that Standard Precision interacts with both Client Reporting ($\chi_1^2 = 7.17$, two-tailed $p < 0.01$) and Accounting Norms ($\chi_1^2 = 3.47$, two-tailed $p = 0.06$), indicating that the level of aggressiveness in client reporting and whether the reporting is consistent with norms once again have different impacts on jury decisions, depending on the precision of standards.¹⁹

To examine whether the specific forms of these interactions are consistent with our predictions, we graph the proportion of juries choosing a verdict against the auditor in Figure 1, Panel B, and we separately model verdicts for the two levels of standard precision (Table 4, Panels B and C). As predicted, under precise standards we find that Client Reporting is highly significant in determining jury verdicts against the auditor ($\chi_1^2 = 28.54$, $p < 0.01$), and neither the main effect for Accounting Norms ($\chi_1^2 = 2.30$, $p = 0.13$) nor the Client Reporting by Accounting Norms interaction term ($\chi_1^2 = 0.55$, $p = 0.46$) is significant. This significant Client Reporting effect can be seen in the Figure 1 as the large vertical separation between the two lines in the left-hand graph in Panel B. The graph shows that aggressive reporting that violates the precise standard is more likely to result in verdicts against the auditor than not, while conservative reporting that complies with the precise standard is extremely unlikely to result in verdicts against the auditor.

Also as expected, Panel C of Table 4 shows that when standards are imprecise, the main effect for Accounting Norms is highly significant ($\chi_1^2 = 19.85$, $p < 0.01$), but neither the main effect for Client Reporting ($\chi_1^2 = 0.00$, $p = 1.00$) nor the interaction term ($\chi_1^2 = 0.00$, $p = 1.00$) is significant. The right-hand graph in Figure 1, Panel B shows minimal vertical separation between the graph lines for conservative and aggressive reporting. Instead, the graph shows that when the

¹⁸ If a case results in a hung jury, the plaintiff could take action to re-try the case. However, re-trying the case a second time is costly. Thus, a trial ending in a hung jury can be viewed as a victory for the defense. Therefore, as a robustness test, we repeated our tests for verdicts with hung juries included as verdicts in favor of the defense. Inferences are identical to those reported above.

¹⁹ The model did not converge when all possible effects were included. Omitting the 3-way interaction allows for convergence and good model fit, so we present the reduced form of the model.

client's reporting is consistent with norms, jury verdicts always support the auditor, but when reporting is inconsistent with norms, jury verdicts are about equally likely to support or go against the auditor.

Similar to our auditor conduct tests, we next compare verdicts in each Precise Standards condition with verdicts in the identical reporting condition under Imprecise Standards. When the client's reporting is aggressive but consistent with norms, 54% of juries find against the auditor when the standard is precise, compared with no (0%) verdicts against the auditor for this same reporting decision under an imprecise standard ($Z = 2.55$, two-tailed $p = 0.01$). If the client's reporting is aggressive and inconsistent with norms, 77% (47%) of juries in the Precise (Imprecise) conditions find against the auditor ($Z = 1.25$, two-tailed $p = 0.21$). This result provides strong evidence that verdicts against auditors do not *increase* under imprecise standards when client reporting is aggressive accounting and inconsistent with norms, but the sizable decrease in verdicts does not reach statistical significance due to low power of the test. We have more power for our tests with individual jurors due to the larger sample size, and when we perform this contrast on individual jurors' verdicts, we find that this difference is strongly statistically significant (73% return verdicts against auditors in Precise condition, 52% return verdicts against auditors in Imprecise condition, $Z = 2.75$, two-tailed $p < 0.01$). This result suggests that when the client's accounting is aggressive, verdicts against auditors are less likely under imprecise standards, even when the accounting is inconsistent with norms.

When the client's accounting is conservative and consistent with norms, no juries find against the auditor under precise or imprecise standards ($Z = 0.00$, $p = 1.00$). Given that there is no difference in proportions across conditions, this non-result cannot be due to a lack of power. However, as further evidence, the difference in proportions remains statistically insignificant in our individual juror results ($Z = 1.21$, two-tailed $p = 0.23$). When the conservative accounting is

inconsistent with norms, 7% of juries return verdicts against the auditor under the Precise standard, compared with 38% under the Imprecise Standard ($Z = 1.58$, two-tailed $p = 0.11$). The more powerful individual juror results for this contrast show a highly significant effect ($Z = 3.09$, two-tailed $p < 0.01$), providing some evidence that when the client's reporting is conservative and inconsistent with norms, verdicts against auditors will increase under imprecise standards.

Overall, the verdicts results corroborate our results for the auditor conduct variables. Client reporting is the primary determinant of perceived auditor conduct and verdicts under precise standards, while consistency with accounting norms is the primary determinant under imprecise standards. When a client's accounting is aggressive, perceptions of auditor conduct are higher and verdicts against auditors are lower under imprecise standards, regardless of whether the accounting is consistent with norms. When a client's accounting is conservative, perceptions of auditor conduct are lower and verdicts against auditors are higher under imprecise standards, but only when the client's reporting is inconsistent with industry norms.

Supplemental analysis: Second-guessing

Recall that in the Conservative reporting conditions we set the audit client's down payment such that only 15% of an independent sample from a similar population deemed the down payment insufficient, a priori, while in the Aggressive Reporting conditions only 15% deemed the down payment sufficient, a priori. These baselines allow us to examine whether juries second-guess the auditor in any of the experimental conditions by comparing the rates of verdicts against the auditor in each condition to 15% in the Conservative reporting conditions and 85% in the Aggressive reporting conditions.

When client reporting is conservative, 38% of juries in the Imprecise Standard/Inconsistent Norms condition found the auditor negligent. This is significantly greater than 15% by the exact

binomial test ($p = 0.03$).²⁰ In all other conditions in which client reporting is conservative, means are not significantly different from 15% by the same test (all $p > 0.05$).²¹ When client reporting is aggressive, we observe the most leniency in the Imprecise Standard/Consistent Norms condition; however, the proportion of juries finding against the auditor is significantly less than 85% in the Imprecise Standard/Inconsistent Norms and Precise Standard/Consistent Norms conditions as well (exact binomial tests, all $p < 0.01$). The rate of verdicts against auditors is statistically equal to 85% only in the Precise Standard/Inconsistent Norms conditions (exact binomial test, $p = 0.43$). In sum, we observe second-guessing in only limited circumstances – in particular, when client reporting is conservative and inconsistent with norms and standards are imprecise. On the other hand, when the client’s reporting is aggressive, we observe surprising leniency in negligence verdicts in most conditions. Juries appear to engage in the opposite of second-guessing in these circumstances, giving auditors the benefit of the doubt unless the reporting violates both a precise standard and a norm.

²⁰ We use an exact binomial test, because the expected cell means are too small to use a chi-square test or a normal approximation to the binomial distribution.

²¹ Walster (1967) defines second-guessing as overestimating the extent to which one could have predicted the consequences of another person’s decision once the outcome of that decision is known. She argues that second-guessing results in individuals receiving blame and praise for chance events. Several studies have examined second-guessing by jurors in auditor negligence suits under the label “outcome effects”. For example, Lowe and Reckers (1994) provide evidence that jurors second-guess auditors by demonstrating that jurors evaluate auditors who issued an unqualified audit opinion more negatively once they know the audit client later declared bankruptcy. Several studies have replicated this “outcome effect” and identified moderators of it (e.g., Lowe and Reckers 2000; Kadous 2001; Clarkson et al. 2002; Lowe et al. 2002). Our method of identifying second-guessing differs from that used in the prior accounting literature. In particular, outcome effects studies typically manipulate whether information about a negative decision outcome is provided or not and compare evaluations of auditors across these conditions. These studies are able to identify whether auditors are evaluated more negatively in light of negative outcome information versus no outcome information; however, the no outcome version can be unrealistic in that negative outcomes are a precursor to litigation. Our method, in contrast, identifies the reporting threshold that most participants would view as appropriate in advance of our main study and compares the proportion of jurors who find the auditor negligent *ex post* given a specific reporting threshold to the proportion that find that same reporting threshold inappropriate *ex ante*. Our method is mainly motivated by our primary purpose of comparing jury judgments under precise and imprecise standards. That is, we needed to identify the precise threshold that our population would interpret as equivalent to the imprecise standard. However, an additional benefit of our method is that it provides a measure of second-guessing without use of unrealistic “no outcome” experimental conditions.

Supplemental analysis: Jurors' pre-deliberation judgments

We repeat our main analyses using jurors' pre-deliberation judgments and verdicts. These analyses support our theory, though they also indicate that norms are powerful benchmarks even under precise standards. In the MANOVA for jurors' ratings of appropriateness and audit quality (not tabulated), the interaction of Standard Precision and Norms is significant ($F_{2, 743} = 4.49$, $p = 0.01$), as is the interaction of Standard Precision and Client Reporting ($F_{2, 743} = 20.19$, $p < 0.01$). When standards are precise, the consistency of client reporting with standards is easy to assess, and Client Reporting is highly significant in determining jurors' assessments of auditor conduct ($F_{2, 344} = 58.46$, $p < 0.01$); however, Accounting Norms are also significant ($F_{2, 344} = 5.11$, $p < 0.01$). When standards are imprecise, Accounting Norms are highly significant in determining jurors' assessments of auditor conduct ($F_{2, 398} = 27.44$, $p < 0.01$), and Client Reporting ($F_{2, 398} = 1.80$, $p = 0.17$) and the interaction term ($F_{2, 398} = 2.66$, $p = 0.07$) are less important. Thus, the overall pattern of inferences for individual jurors is the same as for juries with the exception that norms significantly influence evaluations of auditor conduct—beyond the predicted impact of client reporting—even when standards are precise.

The power of norms is even more pronounced in our analysis of individual jurors' verdicts. In this case, the interaction of Standard Precision and Client Reporting is highly significant ($\chi_1^2 = 26.95$, $p < 0.01$); however, the interaction of Standard Precision and Norms is not ($\chi_1^2 = 0.78$, $p = 0.38$). This lack of significance is driven by norms being highly important under both levels of standard precision. When standards are precise, consistency of client reporting with the standards is the most important determinant of verdicts ($\chi_1^2 = 90.49$, $p < 0.01$), as is true for jury decisions. However, norms are also highly significant ($\chi_1^2 = 10.40$, $p < 0.01$). When standards are imprecise, norms are the most important determinant of verdicts ($\chi_1^2 = 31.97$, $p < 0.01$), but client reporting is also significant ($\chi_1^2 = 6.11$, $p = 0.01$).

Supplemental analysis: Effects of juror demographic variables on jurors' pre-deliberation judgments

In examining jurors' pre-deliberation judgments, we find that jurors' age, level in school, and political leanings are unrelated to their assessments of the appropriateness of auditor behavior (smallest $p = 0.55$) and audit quality (smallest $p = 0.25$), as well as to their verdicts (smallest $p = 0.24$).²² We also find that jury ineligible participants' judgments are insignificantly different from those of jury eligible participants ($t_{729} = 0.49$, $p = 0.62$ for appropriateness, $t_{729} = 0.48$, $p = 0.63$ for quality, and $\chi_1^2 = 0.85$, $p = 0.36$ for verdicts). Gender, on the other hand, is significantly related to jurors' evaluations of auditor judgments. Male jurors rated the appropriateness of the auditor's behavior and decisions ($t_{742} = 3.13$, $p < 0.01$) and audit quality ($t_{742} = 2.65$, $p < 0.01$) more positively than did female jurors. Male jurors were also less likely to find auditors responsible for the audit failure than were female jurors (28% versus 41%; $\chi_1^2 = 13.34$, $p < 0.01$).²³

V. GENERAL DISCUSSION AND CONCLUSIONS

The upcoming move from U.S. GAAP to the more principles-based IFRS is a hot topic for auditors. Auditors have expressed concern that less precise accounting standards will result in increased legal liability (Johnson 2008; Chasan 2008; DiPiazza et al. 2008a; DiPiazza et al. 2008b; Barlow 2009). Our study examines the validity of this concern. Specifically, we conduct an experiment where we examine how jury verdicts against auditors change when we vary the aggressiveness of the audit client's reporting, the precision of the related accounting standard, and whether the client's reporting is consistent with industry norms. Our experimental method allows us to examine how juries evaluate auditors who allow a client reporting choice under a precise

²² We also found that marital status was statistically unrelated to any of our dependent measures (all $p > 0.12$); however, only 11 of our participants reported being married, so sample size is very small for these tests.

²³ In light of the impact of gender on our dependent measures, we added gender as a blocking variable (allowing it to interact with all other independent variables) and repeated the juror-level analyses. The main effect of gender is significant for both auditor conduct measures and verdicts, but none of the interactions involving gender are significant and reported inferences are unchanged.

standard and how their judgments differ when the auditor allows this same reporting under an imprecise standard.

We find that when audit failures occur and the audit client's reporting is conservative, identical client reporting decisions result in more verdicts against the auditor under an imprecise standard than a precise standard. However, this relation holds only when reporting norms are also violated. In our study, approximately 38% of juries find the auditor negligent when the standard is imprecise and the client's accounting is inconsistent with norms, compared to 7% under the precise standard. However, when the reporting choice is instead consistent with industry norms, no juries find the auditor negligent, regardless of standard precision. These findings imply that auditors' concerns about increased liability are not unfounded. Under certain conditions – specifically, when the client's accounting is conservative but deviates from industry norms – auditors experience greater legal liability under imprecise standards. Importantly, however, this increase in liability is predictable and can be avoided if the auditor does not allow clients to deviate from reporting norms.

Our results regarding the legal liability consequences of lower standard precision when the client's accounting is aggressive also should be heartening for auditors. We find that when the client's accounting is aggressive, auditors are *less* likely to return verdicts against auditors under imprecise standards than under precise standards. Specifically, 54% (77%) of our juries find the auditor negligent when the accounting standard is imprecise and the client's reporting is consistent (inconsistent) with industry norms, compared to 0% (47%) under the imprecise standard. Our results suggest that auditors will experience less legal liability for allowing aggressive accounting when accounting standards are imprecise, likely because the standard imprecision makes it more difficult for jurors to establish that the client's reporting was improper. Taken together, our results suggest that imprecision in accounting standards works against the auditor because it makes it more difficult to show that a client's conservative accounting is proper, but imprecision also works in the

auditor's favor because it makes it more difficult to show that a client's aggressive accounting is improper.

Our results show that under imprecise standards, the primary determinant of verdicts against auditors is whether the client's accounting is consistent with industry reporting norms. Thus, our results imply a strong incentive for auditors and preparers to establish reporting norms so that compliance can be unambiguously demonstrated and liability can be avoided. While some argue that precise standards enhance (at least surface) comparability in financial reporting (e.g., Schipper 2003), it is possible that, if standard setters move towards less precise standards, precise norms will arise to take the place of precise standards, leaving comparability high (see also Agoglia et al. 2010). However, this sort of herding in financial reporting would subvert one purpose of less precise principles-based standards, which is to allow firms to use the flexibility of such standards to most accurately convey their economic position. Auditors are unlikely to allow this sort of flexibility if they can avoid liability by creating precise reporting norms.

In addition to the practical implications of our results described above, our study makes several contributions to the academic literature. There are a number of existing studies that examine the effects of accounting standard precision on the behavior of preparers (Psaros and Trotman 2004, Agoglia et al. 2010) and auditors (Trompeter 1994, Hackenbrack and Nelson 1996, Gibbins et al. 2001, Nelson et al. 2002, Kadous et al 2003, Ng and Tan 2003, Segovia et al. 2009). However, our study examines the effects of standard precision on jury behavior. To our knowledge, Donelson et al. (2010) and Becker et al. (2009) are the only other existing studies that examine the effects of standard precision on juror decisions. Donelson et al. (2010) examine the effects of standard precision in federal class action lawsuits, where it is necessary to prove fraud rather than just negligence. Their study focuses on the consequences of these lawsuits for reporting firms, rather than auditors. Similar to our study, the Becker et al. (2009) study examines jurors'

assessments of auditor negligence. Specifically, they examine juror beliefs about auditor culpability under a precise and imprecise lease standard when the client's accounting is relatively conservative. Becker et al. (2009) find that jurors evaluate auditors more negatively under imprecise standards. Based on their results, they conclude that auditors' legal liability will increase under IFRS. Our study fixes methodological issues in Becker et al.'s (2009) experiment and extends their findings in several important ways. To gain a more complete picture of the effects of standard precision on auditor liability, we examine the effects of precision both when the client's financial reporting is conservative, as in Becker et al. (2009), and when the client's accounting is aggressive. This is an important extension because it leads to different, more complex inferences about the litigation consequences of imprecise standards. We also extend Becker et al.'s findings by examining how standard precision interacts with industry norms to determine auditor liability.

Finally, we designed our study such that jurors made individual pre-deliberation judgments and then deliberated and came to a group (jury) decision. Thus, we were able to examine how juror decisions map into jury decisions for a civil (audit negligence) case. We find that inferences are nearly identical whether they are based on jury or juror judgments and decisions. In mapping juror pre-deliberation decisions into jury decisions, we find that of the 89 six-person juries that had an initial majority of jurors' pre-deliberation verdicts and came to a decision, 88 of those decisions (99%) were consistent with the initial majority's decision. Thus, our study provides evidence that individual juror judgments are a reasonably accurate proxy for jury decisions in civil cases.²⁴

²⁴ Thirteen juries with an initial majority for either the auditor or the plaintiff were unable to reach a decision. If we include hung juries in the computations, 79% reached a verdict consistent with the initial majority, less than 1% reached a verdict inconsistent with the initial majority, and 11% resulted in hung juries.

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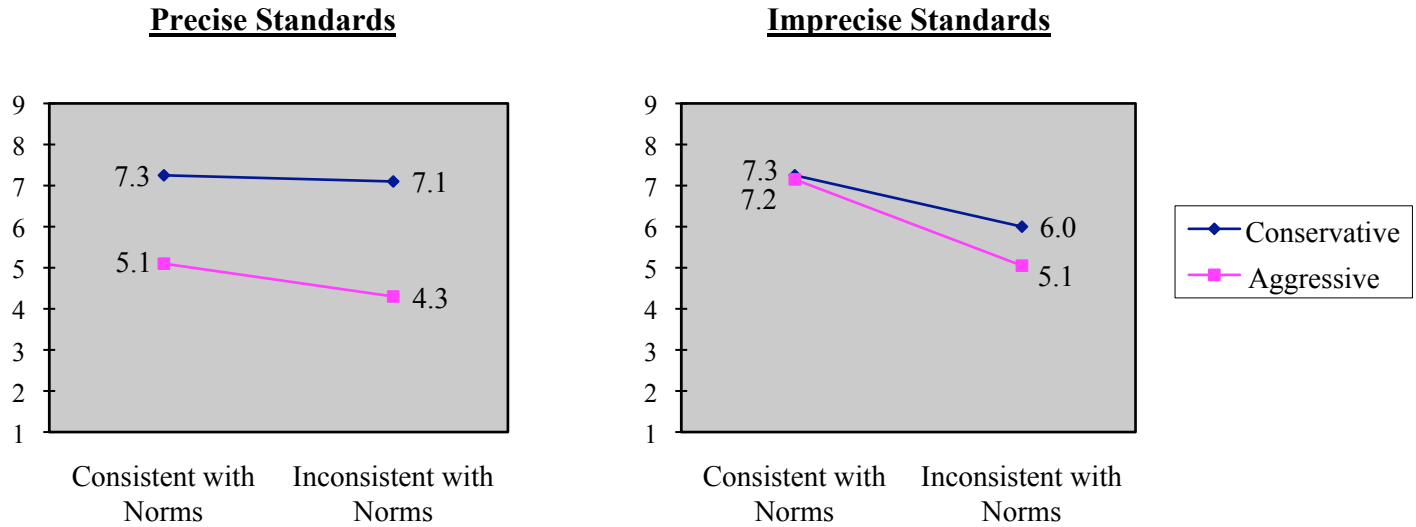
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FIGURE 1
Jury Perceptions of Auditor Conduct & Verdicts

Panel A – Perceived Auditor Conduct



Panel B – Percentage of Verdicts Against Auditor

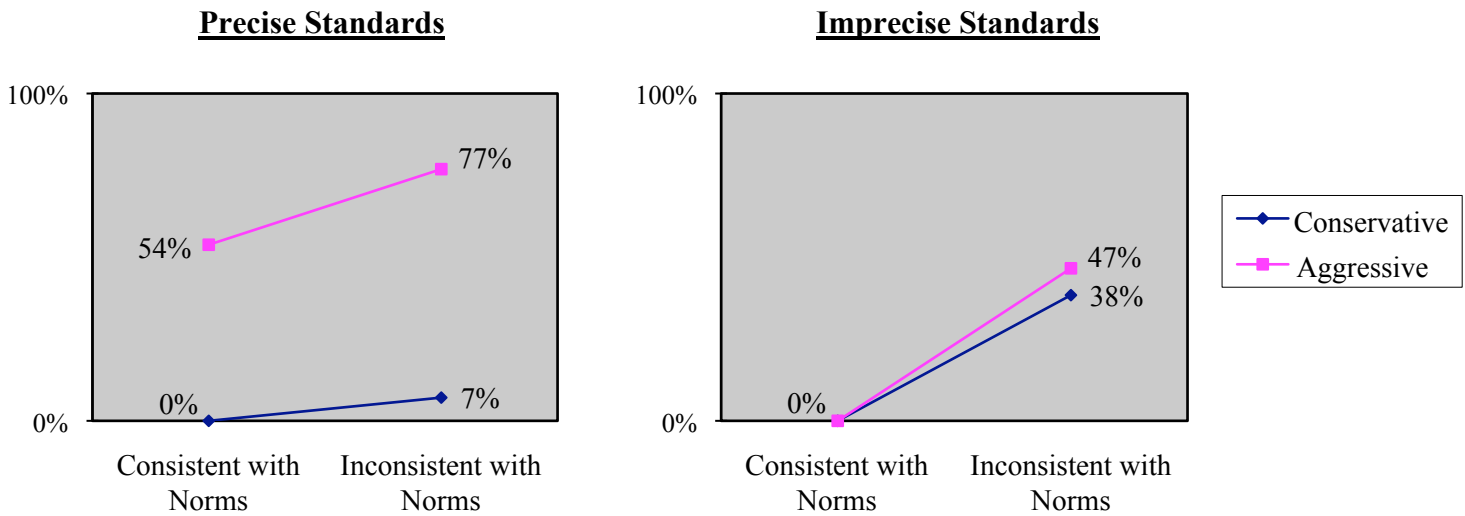


Figure 1 reports jury perceptions of auditor conduct (Panel A) and the percentage of jury verdicts against auditors by experimental condition. The experiment varies whether an audit client’s reporting choice (Conservative, Aggressive), the precision of the related accounting standard (Precise, Imprecise), and whether the accounting choice is consistent with industry norms (Consistent with Norms, Inconsistent with Norms). Jurors deliberate in 6-person juries and assess the appropriateness of the audit firm’s actions and audit quality on 9-point scales. We calculate a composite measure of perceived auditor conduct as the equally-weighted mean of these two assessments. Panel A shows mean perceived auditor

conduct in each experimental condition. In addition to these assessments, each jury also returned an overall verdict. The percentage of jury verdicts against the auditor in each condition is shown in Panel B.

TABLE 1
Jury Perceptions of Auditor Conduct and Jury Verdicts under Precise Standards

Panel A – Mean (Std Dev) Perceived Appropriateness of Auditor Actions under Precise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	7.4 (1.1) n = 15	7.4 (0.8) n = 15	7.4 (0.9) n = 30
Aggressive Reporting	5.3 (1.8) n = 17	4.3 (0.9) n = 14	4.8 (1.5) n = 31
Collapsed Across Client Reporting	6.3 (1.8) n = 32	5.9 (1.8) n = 29	

Panel B – Mean (Std Dev) Perceived Audit Quality under Precise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	7.1 (1.3) n = 15	6.8 (1.3) n = 15	7.0 (1.3) n = 30
Aggressive Reporting	4.9 (1.9) n = 17	4.3 (0.9) n = 14	4.6 (1.5) n = 31
Collapsed Across Client Reporting	5.9 (2.0) n = 32	5.6 (1.7) n = 29	

Panel C – Verdicts under Precise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	For Plaintiff = 0 For Defendant = 14 Hung Jury = 1 Total = 15	For Plaintiff = 1 For Defendant = 14 Hung Jury = 0 Total = 15	For Plaintiff = 1 For Defendant = 28 Hung Jury = 1 Total = 30
Aggressive Reporting	For Plaintiff = 7 For Defendant = 6 Hung Jury = 4 Total = 17	For Plaintiff = 10 For Defendant = 3 Hung Jury = 1 Total = 14	For Plaintiff = 17 For Defendant = 9 Hung Jury = 5 Total = 31
Collapsed Across Client Reporting	For Plaintiff = 7 For Defendant = 20 Hung Jury = 5 Total = 32	For Plaintiff = 11 For Defendant = 17 Hung Jury = 1 Total = 29	

Table 1 reports descriptive statistics for jury assessments of the appropriateness of the audit firm's actions (Panel A), the audit quality (Panel B), and jury verdicts (Panel C) **under precise standards** by experimental condition. Juries

indicated the appropriateness of the audit firm's actions and audit quality on 9-point Likert-type scales. We informed juries that they should come up with a unanimous verdict either for the plaintiff (investor) or for the defendant (auditor), but we allowed juries to be hung if they could not reach a consensus.

TABLE 2
Jury Perceptions of Auditor Conduct and Jury Verdicts under Imprecise Standards

Panel A – Mean (Std Dev) Perceived Appropriateness of Auditor Actions under Imprecise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	7.4 (0.8) n = 20	6.0 (2.2) n = 14	6.8 (1.8) n = 34
Aggressive Reporting	7.2 (1.2) n = 17	5.2 (1.5) n = 18	6.2 (1.7) n = 35
Collapsed Across Client Reporting	7.3 (1.0) n = 37	5.5 (1.9) n = 32	

Panel B – Mean (Std Dev) Perceived Audit Quality under Imprecise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	7.1 (0.9) n = 20	6.0 (1.8) n = 14	6.6 (1.4) n = 34
Aggressive Reporting	7.1 (1.2) n = 17	4.9 (1.6) n = 18	6.0 (1.8) n = 35
Collapsed Across Client Reporting	7.1 (1.1) n = 37	5.4 (1.8) n = 32	

Panel C – Verdicts under Imprecise Standards

	Consistent with Norms	Inconsistent with Norms	Collapsed Across Norms
Conservative Reporting	For Plaintiff = 0 For Defendant = 17 Hung Jury = 3 Total = 20	For Plaintiff = 5 For Defendant = 8 Hung Jury = 1 Total = 14	For Plaintiff = 5 For Defendant = 25 Hung Jury = 4 Total = 34
Aggressive Reporting	For Plaintiff = 0 For Defendant = 12 Hung Jury = 5 Total = 17	For Plaintiff = 7 For Defendant = 8 Hung Jury = 3 Total = 18	For Plaintiff = 7 For Defendant = 20 Hung Jury = 8 Total = 35
Collapsed Across Client Reporting	For Plaintiff = 0 For Defendant = 29 Hung Jury = 8 Total = 37	For Plaintiff = 12 For Defendant = 16 Hung Jury = 4 Total = 32	

Table 2 reports descriptive statistics for jury assessments of the appropriateness of the audit firm's actions (Panel A), the audit quality (Panel B), and jury verdicts (Panel C) **under imprecise standards** by experimental condition. Juries indicated the appropriateness of the audit firm's actions and audit quality on 9-point Likert-type scales. We informed juries that they should come up with a unanimous verdict either for the plaintiff (investor) or for the defendant (auditor), but we allowed juries to be hung if they could not reach a consensus.

TABLE 3
MANOVA Models for Jury Perceptions of Auditor Conduct

Panel A – Full Model

	<i>Numerator df</i>	<i>Denominator df</i>	<i>F</i>	<i>2-tailed p-value</i>
Standard Precision	2	121	2.06	0.13
Accounting Norms	2	121	10.72	< 0.01
Client Reporting	2	121	21.00	<0.01
Standard Precision by Accounting Norms	2	121	3.14	0.05
Standard Precision by Client Reporting	2	121	10.54	<0.01
Accounting Norms by Client Reporting	2	121	1.57	0.21
Standard Precision by Accounting Norms by Client Reporting	2	121	2.58	0.08

Panel B – Precise Standard Conditions Only

	<i>Numerator df</i>	<i>Denominator df</i>	<i>F</i>	<i>2-tailed p-value</i>
Accounting Norms	2	56	1.24	0.30
Client Reporting	2	56	34.11	<0.01
Accounting Norms by Client Reporting	2	56	3.02	0.06

Panel C – Imprecise Standard Conditions Only

	<i>Numerator df</i>	<i>Denominator df</i>	<i>F</i>	<i>2-tailed p-value</i>
Accounting Norms	2	64	12.30	< 0.01
Client Reporting	2	64	1.31	0.28
Accounting Norms by Client Reporting	2	64	1.49	0.23

Table 3, Panel A reports the results of a MANOVA with Standard Precision, Accounting Norms, and Client Reporting as independent variables and jury perceptions of the appropriateness of the audit firm's actions and audit quality as dependent measures. Panels B and C of Table 3 report the results of follow up MANOVAs for only the Precise Standard juries and Imprecise Standard juries, respectively.

TABLE 4
General Linear Models (Logit Link, Binomial Distribution) for Jury Verdicts

Panel A – Full Model

	<i>df</i>	<i>Chi-Square</i>	<i>2-tailed p-value</i>
Standard Precision	1	1.66	0.20
Accounting Norms	1	17.02	< 0.01
Client Reporting	1	10.00	<0.01
Standard Precision by Accounting Norms	1	3.47	0.06
Standard Precision by Client Reporting	1	7.17	<0.01
Accounting Norms by Client Reporting	1	0.55	0.46

Panel B – Precise Standards Only

	<i>df</i>	<i>Chi-Square</i>	<i>2-tailed p-value</i>
Accounting Norms	1	2.30	0.13
Client Reporting	1	28.54	<0.01
Accounting Norms by Client Reporting	1	0.55	0.46

Panel C – Imprecise Standards Only

	<i>df</i>	<i>Chi-Square</i>	<i>2-tailed p-value</i>
Accounting Norms	1	19.85	< 0.01
Client Reporting	1	0.00	1.00
Accounting Norms by Client Reporting	1	0.00	1.00

Table 4, Panel A reports the results of a general linear model with a logit link that examines that effects of Standard Precision, Accounting Norms, and Client Reporting on jury verdicts. Panels B and C report the results of similar models for only the Precise Standard juries and Imprecise Standard juries, respectively.