THE IMPACT OF PROPOSED CHANGES TO THE CONTENT OF THE AUDIT REPORT ON JURORS’ ASSESSMENTS OF AUDITOR NEGLIGENCE

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This study experimentally examines whether and how two potential changes to the audit report, clarification of the meaning of reasonable assurance and inclusion of a mandatory paragraph that identifies and describes a critical audit matter (CAM), affect jurors’ assessments of auditor liability. Overall, we find that clarifying the term reasonable assurance within the audit report reduces auditors’ litigation exposure. We also find that simply identifying a critical audit matter in the audit report does not significantly affect auditors’ negligence likelihood compared to the standard audit report, but jurors are more likely to find auditors negligent when the CAM paragraph includes a description of the specific audit procedures performed to address the identified critical audit matter. However, clarifying the meaning of reasonable assurance in the audit report with this expanded critical audit matter paragraph significantly reduces the likelihood that auditors are found negligent, mitigating the negative unintended consequences of this expanded disclosure. These results inform practitioners, standard setters, and academics on how the proposed changes to the audit report affect juror’s decision making and auditors’ ability to defend their work.

**Keywords:** Audit Report, Auditor Liability, Auditor Negligence, Critical Audit Matter, Reasonable Assurance, Expectations Gap
I. INTRODUCTION

Concerns about the transparency and relevance of the current audit reporting model prompted both the Public Company Accounting Oversight Board (PCAOB) and the International Auditing & Assurance Standards Board (IAASB) to consider changing the content and form of the standard audit report (PCAOB 2011b; PCAOB 2013a; IAASB 2013). Proposed changes to the audit report include clarifying the audit firm’s role in the audited financial statements (PCAOB 2011b) and mandating the disclosure of critical audit matters specific to each audited company (PCAOB 2013a; IAASB 2013). Users of financial statements argue that more information about auditors’ role in the audited financial statements would help narrow the gap between the level of assurance auditors are actually required to provide and the level of assurance users expect, while including critical audit matters in the audit report would enhance the credibility of the audit (CFA 2010). However, audit firms strongly urge standard setters to consider the potential increased liability exposure associated with these changes before finalizing the new reporting model (PCAOB 2011c; PCAOB 2011d; PCAOB 2011e; PCAOB 2011f; PCAOB 2011g; PCAOB 2011h; PCAOB 2011i; PCAOB 2011j; PCAOB 2011k). This study directly informs auditors, standard setters, and academics about the ramifications of these proposed changes by examining how the inclusion of language that clarifies the level of assurance provided by auditors and the reporting of critical audit matters in the audit report affect jurors’ evaluations of auditor negligence.

Prior research consistently finds that users of financial statements expect auditors to provide a higher level of assurance than is required in the auditing standards (Asare and Wright 2012; Hogan et al. 2008; Lo and Boo 2012; McEnroe and Martens 2001; Reffett et al. 2012).

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1 While conceptually similar, the PCAOB (2013a) and the IAASB (2013) use slightly different terminology for these matters with the PCAOB labeling such issues as critical audit matters and the IAASB referring to them as key audit matters. For expositional convenience, we adopt the PCAOB’s terminology throughout this manuscript.
This gap in expectations is concerning because a key criteria jurors consider when assessing negligence is whether or not auditors breached their duty to provide reasonable assurance that the financial statements are free from material errors (Causey and Causey 1991). Thus, it is important that the benchmark against which jurors evaluate auditors’ actions is consistent with auditors’ responsibilities per the auditing standards. According to current auditing standards, reasonable assurance is a high level of assurance, but it is not absolute (AU 230.10, PCAOB 2006). Therefore, reasonable assurance does not guarantee the detection and correction of all material misstatements. We argue that highlighting the limitations of reasonable assurance in the audit report, which is the auditor’s primary means of communicating information, will lower jurors’ expectations regarding auditors’ responsibilities and enable them to attribute some of the blame for the misstatement to the constraints imposed by the auditing standards. This, in turn, will reduce jurors’ perceptions of auditors’ causal control over the adverse outcome, a key factor considered when assessing auditor negligence (Backof 2014).

In addition to clarifying technical terms in the audit report, many argue that including audit-specific information would enhance the usefulness of the audit report (Carcello 2012; Church et al. 2008; CFA 2011; Mock et al. 2013). Current auditing standards permit the discretionary use of emphasis paragraphs (AICPA 1995), but the PCAOB’s (2013a) and the IAASB’s (2013) proposals would require their use in all public company audit reports to highlight critical audit matters (e.g., significant management judgments and estimates, areas with

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2 In order to prove auditor negligence, the plaintiff must convince the jury that the auditor had a duty, the auditor breached that duty, the plaintiff suffered a loss, and the auditor’s breach of duty was the proximate cause of the plaintiff’s loss (Causey and Causey 1991).

3 SAS 79 gives auditors discretion to add language to the auditor’s report to emphasize matters that are appropriately disclosed in the financial statements. Examples of matters the auditor could emphasize are (1) that the entity is a component of a larger business enterprise, (2) that the entity has had significant transactions with related parties, (3) unusually important subsequent events, and (4) accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period (AICPA 1995, 3).
significant measurement uncertainty, etc.). Prior research finds that auditors’ identification of fraud risks (Reffett 2010), as well as their documentation of the audit work performed to address risks of material misstatements (Backof 2014), affects jurors’ decision-making. However, what is unclear from prior research, and what this study specifically investigates, is how the disclosure of critical audit matters in the public audit report affects auditors’ liability. Unlike the audit workpapers that contain information related to all aspects of the audit, only the most difficult aspects of the audit will be included in the public audit report. We argue that highlighting the difficulty encountered when auditing these specific matters will heighten jurors’ perceptions of the likelihood of a material misstatement associated with those particular matters. Consequently, we expect that jurors’ will view an undetected misstatement associated with a reported matter as more foreseeable at the time of the audit, which is another key determinant of auditors’ liability (Backof 2014). Given that both of these proposed changes may be adopted, we also investigate how the inclusion of critical audit matters interacts with the clarification of reasonable assurance to affect jurors’ decision making.

To examine the influence of the proposed changes to the audit reporting model on jurors’ decision making, we conduct an experiment using a 2 x 3 factorial design in which participants assume the role of jurors in a case alleging auditor negligence adapted from Backof (2014). Importantly, no new information is introduced in any of the conditions. Only the content of the audit report, and not the overall mix of available information, differs across conditions. All of the information disclosed in any given audit report is also included in the testimony and audit workpapers provided to all of the participants during the experimental trial.

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4 Our materials were adapted from the alternatives presented and risks linked to procedures condition reported in Backof (2014). We used this condition because jurors are most likely to find auditors negligent (57%), but award the lowest damages in this condition (Backof 2014). This provides the strongest setting for testing the effect of the inclusion of the critical audit matter paragraph and clarifying language on auditor negligence.
We manipulate *clarifying language* at two levels. Half of the audit reports clarify that auditors are required to provide high, but not absolute, assurance and, therefore, audits conducted in accordance with generally accepted auditing standards may not detect a material misstatement. The other half of the reports contain no such clarifying language. Our second independent variable, *CAM paragraph*, is manipulated at three levels. In the *no CAM* condition, the audit report does not include a critical audit matter paragraph. Given the debate surrounding the actual content of a critical audit matter paragraph (IAASB 2013; PCAOB 2013a), we developed two CAM paragraph conditions to examine how different levels of auditor disclosure affect jurors’ assessments of auditor liability. Our *CAM* condition includes a paragraph that highlights the risk of material misstatement and why the auditors identified that risk as a critical audit matter. The same paragraph is included in the *CAM with procedures* condition, with additional language describing the specific audit procedures performed to address the risk of material misstatement. This third condition is important because both the PCAOB and the IAASB considered mandating that discussions of critical audit matters in the audit report also include a description of the procedures carried out to address those matters (PCAOB 2013a; IAASB 2013). While this mandate is excluded from the current proposals, auditors are not precluded from including their procedures in the critical audit matter paragraphs. Further, illustrative examples provided in the proposed standards include such procedures, which will likely lead audit firms to infer that those descriptions are expected (PCAOB 2013b). Thus, we include the *CAM with procedures* condition to investigate another controversial aspect of the proposed changes to the audit report.

Overall, our results indicate that clarifying the term reasonable assurance within the audit report significantly influences jurors’ assessments of auditor negligence. Specifically, jurors perceive auditors as having less causal control over the misstatement and, therefore, are less
likely to find auditors negligent when the audit report clarifies the limitations of reasonable assurance. We also find that the degree to which the disclosure of a critical audit matter influences jurors’ decision making depends on the level of auditor disclosure and the presence of clarifying language. Compared to the standard audit report, simply identifying a critical audit matter does not significantly affect auditors’ negligence likelihood. However, when the standard audit report also includes a description of the specific audit procedures performed to address the identified critical audit matter, jurors perceive the misstatement as more foreseeable and, consequently, are more likely to find the auditor negligent. Further, we find that clarifying what is meant by reasonable assurance mitigates the negative unintended consequences of this expanded critical audit matter paragraph. In particular, this language reduces jurors’ expectations regarding the level of assurance provided by the audit firm given the limitations imposed by the auditing standards. This lowered benchmark reduces jurors’ perceptions of the foreseeability of the misstatement at the time of the audit, which, in turn, reduces auditors’ negligence likelihood.

Taken together, these findings highlight the benefits associated with clarifying reasonable assurance in the audit report, which is particularly interesting in light of the PCAOB’s decision to exclude such clarifying language from its updated proposed standard (PCAOB 2013a).

This study contributes to both practice and research in several ways. First, the current pass/fail reporting model has changed little in the last 70 years (PCAOB 2013a). Two main critiques of the current audit report are that it contains technical terms that are open to misinterpretation and fails to provide any audit-specific information (IAASB 2013; PCAOB 2013a). Although auditors agree that the audit reporting model needs to evolve to meet the needs of the users of the financial statements, audit firms caution standard setters to also consider any unforeseen costs associated with such changes (PCAOB 2011g; PCAOB 2011h; PCAOB 2011j;
This study specifically addresses auditors’ concerns and finds that only expanded critical audit matter paragraphs that describe specific audit procedures performed by the audit firm increase auditors’ negligence likelihood. Interestingly, clarifying the meaning of reasonable assurance effectively mitigates this increase in auditors’ liability exposure associated with these expanded disclosures. Therefore, audit firms may want to push for reincorporation of this clarifying language into the final audit reporting model standard as a noninvasive way to offset the negative impact of critical audit matter paragraphs on auditor litigation risk.

Second, auditors and regulators are concerned about the sustainability of the audit profession given the potential for catastrophic claims in civil litigation brought by investors and the companies that they audit (The Department of the Treasury 2008). Audit firms spend more than 15% of audit-related revenues on litigation-related costs (Deloitte 2010) and paid almost $5.6 billion to settle litigation-related matters from 1996 thru 2007 (The Department of the Treasury 2008). Audit firms often feel pressured to settle cases rather than risk a jury finding them negligent and awarding damages in an amount that could threaten their survival (Oberly 2008). Our study contributes to the auditor negligence literature, as well as informs practice and the standard setters, by providing evidence on how the proposed changes affect jurors’ decision making and auditors’ ability to defend their work.

Finally, our study contributes to the prior auditing literature examining the persistence of the expectations gap. Technical terminology used in the audit report can be easily misinterpreted (AICPA 1978). Although subsequent standards have attempted to clarify many of these technical

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5 Given the concerns surrounding any changes to the existing audit reporting model, it is important to examine the ramifications of these proposed changes from multiple angles. Consequently, other researchers (e.g., Brasel et al. 2014) have also begun to examine the issues surrounding the inclusion of audit-specific information in the audit report.

6 Of these settlements, the majority relates to state law litigation (i.e., negligence) rather than securities class actions (Donelson et al. 2014).
terms (e.g., AICPA 1992), a gap persists between the level of assurance expected and the actual level of assurance delivered by auditors (Asare and Wright 2012; Hogan et al. 2008; Lo and Boo 2012; McEnroe and Martens 2001; Reffett et al. 2012). We find that clarifying the meaning of reasonable assurance reduces this expectations gap by lowering jurors’ perceptions regarding the level of assurance the auditor is required to provide, as well as their assessments of auditors’ (rather than the limitations imposed by the auditing standards) causal control over the undetected misstatements. This reduction in expectations, in turn, reduces auditors’ liability on its own and mitigates the increased liability risk associated with a more detailed critical audit matter paragraph disclosure.

The remainder of this manuscript proceeds as follows: Section II describes the theoretical underpinnings of our predictions. We explain our research method and experimental design in Section III, while Section IV describes the results of our study and tests of our hypotheses. Finally, Section V summarizes the implications of our findings.

II. THEORETICAL DEVELOPMENT

Changes to the Standard Audit Report

The audit report is the primary means by which auditors communicate information to external users of the financial statements. Critics of the current form of the audit report frequently cite users’ uncertainty regarding the level of assurance provided by auditors and the lack of specific information related to the audit as limitations to the report’s communicative value (Asare and Wright 2012; Carcello 2012; Mock et al. 2012). The PCAOB and IAASB are considering a number of potential changes to the content and form of the standard audit report in

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7 According to the PCAOB’s Chief Auditor and Director of Professional Standards, Martin Baumann, the audit report is “the audit’s most visible product,” and current efforts to improve the report are “one of the most compelling issues of the day” (Baumann 2013).
an effort to improve the report’s informativeness (PCAOB 2011a; IAASB 2013). One of the changes under consideration would clarify the meaning of reasonable assurance within the body of the audit report (PCAOB 2011b), while another would require identification of audit-specific matters of critical importance in critical audit matter paragraphs (PCAOB 2011b; PCAOB 2013a; IAASB 2013). Although audit firms believe these changes will improve users’ understanding of the audit function and the relevance of the audit report, respectively, they are concerned about the associated potential increased litigation risk (Katz 2014; PCAOB 2011g; PCAOB 2011h; PCAOB 2011j; PCAOB 2011k).

Jurors responsible for evaluating auditor negligence typically do not have any audit experience (Fulero and Penrod 1990; Zeisel and Diamond 1976). This lack of understanding of auditors’ responsibilities and the audit process threatens jurors’ ability to objectively evaluate allegations of auditor negligence in accordance with prescribed legal standards. While the two proposed changes to the audit report examined in this study have the potential to improve jurors’ understanding of the audit of the financial statements, it is important to investigate how clarifying the meaning of reasonable assurance and disclosing critical audit matters will impact the auditors’ litigation risk before such changes are mandated.

**Jurors’ Assessments of Auditor Negligence**

We rely on the Culpable Control Model (CCM) of blame attribution (Alicke 2000) to predict and test how the proposed changes in the audit report will affect jurors’ evaluations of auditor negligence. The CCM, as depicted in Figure 1, captures the cognitive process by which jurors evaluate auditor negligence (Backof 2014). Consistent with prior literature (e.g., Kadous 2001; Reffett 2010), this model suggests that jurors’ negative affective reactions to the details of the case impact their evaluations of auditor negligence. However, the incremental utility of the
CCM above and beyond theories documented in prior studies of auditor negligence is that this comprehensive model of jurors’ decision making provides a bridge from jurors’ affective reactions to their assessments of blame. In particular, the CCM explains that jurors’ evaluations of auditor negligence are also impacted by their assessments of auditors’ personal control over the misstatement. The criteria used to assess personal control over a negative outcome include the actor’s intention to avoid the negative outcome, the foreseeability of the outcome, and the actor’s causal control over the outcome (Alicke 2000). Our study relies on the CCM to develop our hypotheses and explain how the inclusion of clarifying language and critical audit matter paragraphs affect jurors’ perceptions of auditors’ personal control, which, in turn, directly impacts their evaluations of auditor negligence.

[INSERT FIGURE 1 HERE]

Clarifying Reasonable Assurance

As stated in the scope paragraph of the current audit report, auditing standards require auditors to provide reasonable assurance that the financial statements are free of material misstatements (AU 230.10; PCAOB 2006). However, the ambiguity surrounding reasonable assurance and other technical language used in the auditor’s report has remained part of the larger debate over the report’s understandability for more than thirty years (Church et al. 2008; Gray et al. 2011). In 1978, the AICPA’s Commission on Auditors’ Responsibilities determined that such language could easily mislead users of financial statements and recommended elimination of its use (AICPA 1978). The literature since the Commission’s 1978 report supports the Commission’s concerns regarding users’ disparate interpretations of technical terms (e.g., Asare and Wright 2012; Gray et al. 2011; Harrington 2003; McEnroe and Martens 2001; Rezaee 2004; Zeff 1992), and also finds that the interpretation of such terms varies greatly among
practicing auditors (Asare and Wright 2012; Gray et al. 2011). Consequently, the PCAOB considered clarifying technical terminology within the audit report in order to “provide additional explanation about what an audit represents and the related auditor responsibilities” (PCAOB 2011b, 27).  

While the PCAOB’s 2011 concept release suggested several terms whose meanings could be clarified in the audit report, this study focuses specifically on the effect of clarifying the meaning of reasonable assurance. The auditing standards explain that auditors are only required to provide reasonable assurance that the financial statements are free of material misstatements, meaning that an audit conducted in accordance with the auditing standards may not detect a material misstatement (AU 230.10; PCAOB 2006). However, the current audit report not only fails to clarify the difference between absolute and reasonable assurance, but is also silent as to the limitations of an audit conducted in accordance with the standards. The ambiguity of this term as it is currently used in the audit report contributes to the variability in expectations about the level of assurance that auditors are required to provide on any given audit (Asare and Wright 2012; Hasan et al. 2005; Hogan et al. 2008; Lo and Boo 2012; McEnroe and Martens 2001; Reffett et al. 2012).

Jurors’ perception of the required level of assurance on any given audit is particularly important when determining auditor negligence. Auditors have a duty to exercise due professional care (AU 230.01; PCAOB 2006) by obtaining reasonable assurance about whether the financial statements are free of material misstatement (AU 230.10; PCAOB 2006). In order to be found negligent, jurors must determine that auditors breached this duty (Causey and

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8 Despite support from many commenters, including each of the Big 4 audit firms, on the PCAOB’s original concept release regarding inclusion of clarifying language, the proposed audit reporting standard released on August 13, 2013 does not include a proposal to include such language in the report. Nonetheless, we maintain this component of our research design for the reasons described in this section.
Causey 1991). Therefore, we contend that jurors’ perceptions of auditors’ responsibility for detecting and correcting all material misstatements are an important factor affecting auditors’ liability risk as their perceptions of the limitations of reasonable assurance serve as the benchmark against which auditors’ actions are evaluated.

Clarifying in the audit report that an audit conducted in accordance with auditing standards does not provide absolute assurance and may not detect a material misstatement likely increases, for jurors, the salience of the limitations on the auditor’s responsibilities and highlights the importance of those limitations. In other words, while an undetected misstatement may be attributable to a negligent auditor, the audit report reminds jurors that it may also be attributable to the fact that the auditing standards do not require absolute assurance. Alicke (2000) argues that any such constraint on the accused party’s personal control over the adverse outcome should mitigate blame. Further, Kelly (1973, 113) explains that “the role of a given cause in producing a given effect is discounted if other plausible causes are also present” (Kelly 1973, 113).

Consequently, we expect that jurors will discount the role of auditors’ actions in causing the misstated financials when the audit report clarifies the limitations of reasonable assurance. This is important because the Culpable Control Model suggests that jurors’ perceptions of auditors’ causal control over the adverse outcome are a key determinant of their assessments of auditors’ personal control, which directly affect jurors’ negligence decisions (Backof 2014). Therefore, we predict that jurors will perceive auditors as having less causal control over the misstated financials when the audit report clarifies the meaning of reasonable assurance because the clarification will highlight that the auditors’ responsibility to detect material misstatements is limited according to auditing standards. This, in turn, will lower the likelihood that auditors are found negligent. Stated formally, we hypothesize the following:
**H1:** Jurors’ evaluations of auditor negligence will be lower when the audit report includes language that clarifies the term reasonable assurance compared to when such language is not included in the report.

*Mandatory Critical Audit Matter Paragraph*

In an effort to provide more relevant and specific information related to the audit, the PCAOB and IAASB are also considering mandating that the audit report include a paragraph that describes matters identified by the auditors as critical to the financial statements taken as a whole (PCAOB 2013a; IAASB 2013). This proposal directly addresses complaints about the lack of company-specific information in the standard audit report (e.g., Asare and Wright 2013; Church et al. 2008). For example, over seventy-seven percent of respondents to a recent survey developed by the PCAOB’s Investor Advisory Group indicated that the audit report should disclose the areas that pose the greatest financial statement and audit risk, and describe the audit work performed in those areas (PCAOB 2011). Similar responses were provided to surveys conducted by the Chartered Financial Analysts Institute, suggesting users want more specific information about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with required financial reporting standards (CFA 2008; 2010; 2011). Although the inclusion of critical audit matters in the audit report arguably increases the transparency of the audit process and reduces the information asymmetry between company management and investors, Richard Murray, former head of legal affairs at Deloitte, warns that requiring auditors to disclose those matters of greatest concern would open the audit firms up to even more litigation because many would question how the audit firm was able to

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9 Consistent with the IAASB (2013), the PCAOB defines critical audit matters as those matters addressed during the audit that “(1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements” (PCAOB 2013a, 15).

10 The survey was distributed to more than 300 investment professionals employed at investment banks, hedge funds, private equity funds, mutual funds, pension funds, and endowments. Many of the respondents held positions of leadership within their respective institutions, such as CEOs, presidents, managing directors, CFOs, controllers, CIOs, equity analysts, portfolio managers, and credit analysts (Carcello 2012).
issue a clean opinion despite these acknowledged concerns (Katz 2014). This study specifically addresses this concern by investigating how the disclosure of company-specific critical audit matters affects jurors’ decision making.

Prior auditing research provides some insight into how auditors’ identification of, and investigation into, risks of material misstatements affect auditors’ negligence likelihood. Reffett (2010) finds that jurors are more likely to hold auditors liable for failing to detect fraud when auditors identify the perpetrated fraud as a fraud risk than when they do not. This is because jurors perceive auditors who identified the fraud risk as being close to detecting the fraud, making it easier for jurors to imagine what auditors could have done differently to prevent the fraud’s occurrence. Backof (2014) extends this line of research by examining how the documentation of the audit procedures performed to address the identified risks influences jurors’ evaluations of auditor negligence. Holding the audit work constant, jurors perceive the misstatement as more foreseeable when auditors document their consideration of alternative accounting treatments rather than simply documenting the facts consistent with the accounting treatment followed. This, in turn, increases auditors’ negligence likelihood.

While these two studies provide unique insights into jurors’ decision making process based on auditors’ proprietary information disclosed during the trial, it is unknown whether and how the public disclosure of audit-specific information affects juror evaluations of auditors’ negligence likelihood. Unlike the proprietary audit workpapers discussed during the trial that include auditors’ identification and response to all of the identified risks of material misstatement, auditors must use their judgment in deciding which matters are deemed critical enough to be included in the public audit report. Highlighting a specific risk of material misstatement in the audit report increases the salience of that risk and arguably sends a signal
that the audit firm believes that the disclosed critical audit matter poses a significant risk for a material misstatement. Prior research warns that individuals such as jurors who do not possess audit knowledge or experience are unlikely to understand how to interpret the disclosed information (Church and Kuang 2009; Malmendier and Shanthikumar 2007). Consequently, rather than viewing auditors’ disclosure of a critical audit matter as a mitigating factor that fulfills auditors’ fiduciary duty to inform the investing public about difficult areas of the audit, we argue that the public forewarning is more likely to exacerbate jurors’ perceptions of the likelihood of a misstatement associated with the disclosed critical audit matter. Therefore, when a material misstatement related to a critical audit matter goes undetected, we expect that jurors will perceive the misstatement as more foreseeable when the audit report discloses the critical audit matter related to the undetected misstatement than when it does not. Formally stated, we hypothesize the following:

**H2:** Jurors’ evaluations of auditor negligence will be higher when the audit report includes a critical audit matter paragraph compared to when no such paragraph is included.

*Does Clarifying Language Moderate the Effect of Critical Audit Matter Paragraphs on Jurors’ Evaluations of Auditor Negligence?*

Because the two proposed changes to the audit report investigated in this study are not mutually exclusive (PCAOB 2011b, 2), we also examine the potential for clarifying what is meant by reasonable assurance to moderate the effect of critical audit matter paragraphs on jurors’ evaluations of auditor negligence. The theory for H2 argues that highlighting a critical audit matter in the audit report will increase jurors’ perceptions of the foreseeability of an undetected misstatement associated with the specific risk of material misstatement deemed to be a critical audit matter. We argue that clarifying the limitations of reasonable assurance in the audit report may help mitigate any unintended consequences associated with the mandatory
reporting of critical audit matters by lowering jurors’ expectations regarding auditors’ responsibilities for detecting and correcting all material misstatements, even those associated with the critical audit matter highlighted in the audit report. In particular, we expect that jurors will perceive the likelihood of an undetected material misstatement to increase as their expectations surrounding the assurance provided by auditors decreases. Consequently, jurors with lower expectations regarding auditors’ responsibilities for detecting and correcting all material misstatements before issuing a clean opinion will likely perceive any undetected misstatement as less foreseeable based on the required amount of work to be performed at the time of the audit than those jurors holding auditors to a higher benchmark. This reduction in the perceived foreseeability of the undetected misstatement, in turn, will diminish the negative effect of including the critical audit matter paragraph on jurors’ negligence assessments. This leads to the following formal hypothesis:

**H3**: Jurors’ evaluations of auditor negligence will be lower when language that clarifies the term reasonable assurance and a critical audit matter paragraph are simultaneously included in the audit report, relative to when only a critical audit matter paragraph is included.

### III. RESEARCH DESIGN

**Research Participants**

We employ a 2 x 3 between-participants factorial design to test our hypotheses. Consistent with Kadous and Mercer (2012), our sample of research participants is comprised of undergraduate students enrolled in an introductory accountancy course at a large southeastern U.S. public university.\(^{11}\) Admittedly, auditors are evaluated by many different parties including...

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\(^{11}\) The undergraduate students volunteered for extra credit worth approximately one percent of their final grade in the introductory accounting course in which they were enrolled at the time the study was conducted. Students who
nonprofessional jurors, regulators, and peer professionals. However, Bornstein (1999) finds that verdicts from student participants do not differ significantly from verdicts provided by a more diverse group of jury-eligible adults. Further, Libby et al. (2002) and Kachelmeier and King (2002) support the use of students in a study examining general cognitive responses to information learned in the experimental setting where there is no theory that suggests that students’ belief revision process differs from that of a more diverse jury pool. Given that jurors with any expertise related to the issues in a civil case are generally eliminated from the jury pool (Fulero and Penrod 1990; Zeisel and Diamond 1976), our participants’ knowledge about the accounting standards is comparable to jurors in a real auditor negligence trial (Kadous and Mercer 2012). Thus, consistent with recent audit litigation research (e.g., Kadous and Mercer 2012; Peecher and Piercey 2008; Reffett 2010), we use students as our mock jurors.

**Experimental Materials and Procedures**

At the beginning of each experimental session, participants were given a general overview of the study’s purpose and how the information collected would be used. Participants were then asked to assume the role of a juror in a professional negligence case during the experiment. All participants received a sealed packet containing the experimental materials, which included a written transcript of the trial, copies of all documents submitted as evidence, an audio player and headphones, and a compact disc containing an audio transcript of the trial.\(^{12}\)

The experimental case was adapted from Backof (2014). The primary accounting issue in the case relates to a lower-of-cost-or market inventory valuation judgment. Specifically, a creditor of the audit firm’s client alleges that the audit firm was negligent in its audit of the

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\(^{12}\) Jurors in an actual negligence trial would hear the oral testimony, as well as see the actual evidence presented during the trial. Therefore, to enhance the external validity of our experimental design, we provide an audio recording of the trial in addition to the written transcript containing copies of the documents entered into evidence.
inventory account. This alleged negligence resulted in a material overstatement in the financial statements upon which the creditor relied when making its lending decision. After the misstatement came to light, the company filed for bankruptcy and the creditor incurred significant losses.

The proceedings of the trial consisted of the plaintiff’s complaint, the defendant’s answer, both attorneys’ opening statements, testimony from both the plaintiff’s and defendant’s expert witnesses, cross-examination of both expert witnesses, testimony from both the plaintiff and defendant’s damages experts, closing statements from both attorneys, and the judge’s instructions to the jury. It is important to note that only the audit report entered into evidence differed across conditions. Regardless of their experimental condition, all jurors heard testimony that clarified the limitations of “reasonable assurance” and described the audit procedures employed to address the critical audit matter emphasized in the audit report. By holding constant the information across all conditions, we are able to capture the pure effects of including clarifying language and disclosing critical audit matters in the public audit report.

After receiving the judge’s instructions, the participants proceeded to the deliberation phase of the study. The American Bar Association requires that jurors have access to all exhibits admitted into evidence during the course of the trial during their deliberations (ABA 2005). The booklet provided to participants in this second phase restated the plaintiff’s complaint and defendant’s answer, the judge’s instructions, and the exhibits entered into evidence. This phase of the experiment concluded by asking each participant to rate the likelihood that the audit firm was negligent and provide a binary verdict decision. Only those participants who voted “guilty” were asked to provide an amount of monetary damages to be awarded to the plaintiff. During the
third and final phase of the experiment, participants responded to a series of general questions about the trial and provided demographic information about themselves.

**Independent Variables**

We manipulated two variables in this study: *clarifying language* and *CAM paragraph* (See Appendix A). Our first independent variable, *clarifying language*, was manipulated at two levels. The participants in the *no clarify* condition reviewed the current wording in the scope paragraph of the standard audit, while the audit report in the *clarify* condition contained an enhanced description of reasonable assurance based on the language found in existing auditing standards (e.g., AU 230.10, PCAOB 2006). In an experimental study examining users’ understanding of differential assurance levels provided through different types of assurance engagements, Lo and Boo (2012) find that providing contrasting statements regarding what level of assurance is and is *not* provided yielded the most appropriate interpretation of the term. Therefore, the *clarify* condition contained the following contrasting description of reasonable assurance:

> Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable assurance that material misstatements are detected. Reasonable assurance is a high level of assurance, but not absolute. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.\(^{13}\)

Our second independent variable, *CAM paragraph*, was manipulated at three levels. In the *no CAM* condition, the audit report is presented without the inclusion of an emphasis paragraph highlighting the critical audit matter. However, when it comes to the content of the actual critical audit matter paragraph, there has been a heated debate surrounding the necessity and appropriateness of requiring auditors to include a discussion of the audit procedures.

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\(^{13}\) This language was adapted from that provided in AU sec. 230, *Due Professional Care in the Performance of Work*. 
performed related to the identified critical audit matter (PCAOB 2013a; IAASB 2013). Therefore, we include two CAM conditions to examine whether the effect of providing audit-specific information on jurors’ assessments of auditor liability varies across different levels of auditor disclosure. The CAM condition includes a paragraph that identifies management’s lower-of-cost-or-market valuation of ending inventory as a critical audit matter. The CAM with procedures condition contains this same paragraph, with additional language describing the specific audit procedures performed to address the risk of material misstatement.

**Dependent Variables**

The primary purpose of this study is to investigate the effects of the proposed changes in the audit report on jurors’ negligence decisions. Therefore, our main dependent variables are participants’ ratings of the likelihood that the audit firm acted negligently (0 = Not at all likely, 10 = Extremely likely) and their binary verdict decisions (guilty, not guilty). In an effort to further understand how these proposed changes will affect auditors’ liability, we also gathered several other measures underlying jurors’ decision making process. We captured jurors’ perceptions of the level of assurance provided by the audit firm (0 = No assurance, 10 = Absolute assurance), as well as the intensity of their counterfactual thoughts regarding what the auditors could have done differently (0 = Not at all seriously, 10 = Very seriously). In addition, we measured jurors’ perceptions of auditors’ causal control over the adverse outcome, as well as the foreseeability of the misstatement. Consistent with Backof (2014), jurors rated the extent to which auditors’ caused the plaintiff’s loss (0 = Not at all the cause, 10 = Completely the cause) and the foreseeability of the misstatement (0 = Not at all foreseeable, 10 = Completely foreseeable).
IV. RESULTS

Descriptive Statistics

A total of 242 undergraduate students voluntarily participated in the study.\textsuperscript{14} The average age of the participants was 20 and 55\% were male. To assess the extent to which participants understood the accounting issue underlying the misstatement, we asked our participants to identify the reason for the misstatement. Only 5.4\% of our participants failed to understand that the valuation of the inventory was misreported on the balance sheet. Results of our primary analyses are substantively similar when we exclude those participants who did not indicate that the issue was one of valuation. Therefore, reported results are based on the entire sample of participants described above. Table 1 contains the means for all measured variables, including jurors’ auditor negligence likelihood judgments and their mean verdict decisions.

[INSERT TABLE 1 HERE]

To verify that the manipulation of clarifying language had the intended effect on the underlying construct, the post-experimental questionnaire asked jurors to rate the level of assurance that the audit firm is required to provide (0 = No assurance, 10 = Absolute assurance). As expected, jurors deemed the standards as requiring a lower level of assurance that the financial statements are free of material misstatements when the audit report included the clarifying language (mean = 5.98) than when such clarification was missing from the report (mean = 7.49, $F_{1,236} = 42.70$, one-tailed $p < 0.001$). This suggests a successful manipulation of clarifying language.

As for the manipulation of the critical audit matter paragraph, the post-experimental questionnaire asked jurors to rate how much the audit firm discussed the critical audit matter in

\textsuperscript{14} We also ran this study with 24 individuals called for jury duty in a federal district court. Inclusion of those participants does not affect the inferences drawn from our reported analyses.
the audit report (0 = No discussion, 10 = A lot of discussion). Jurors deemed the discussion of
the critical audit matter to be greater when the audit report included a critical audit matter
paragraph (mean = 5.49) compared to when the audit report lacked any such audit-specific
information (mean = 4.82, F\(_{1,236}\) = 5.91, one-tailed p = 0.008). This also suggests a successful
manipulation of the critical audit matter paragraph.

Tests of Hypotheses

To test our hypotheses, we estimate an ANOVA model of jurors’ negligence likelihood
assessments. Table 2, Panel A contains the ANOVA table, and Panel B contains the planned
contrasts. We also estimate a generalized linear model with a logit link to determine whether our
independent variables affect jurors’ binary verdict decisions.\(^\text{15}\) The results of this analysis and the
planned contrasts are presented in Table 3.

[INSERT TABLE 2 HERE]

[INSERT TABLE 3 HERE]

Test of H1

H1 predicts that jurors’ evaluations of auditor negligence will be lower when language
that clarifies what is meant by reasonable assurance is added to the standard audit report. To test
this hypothesis, we perform a linear contrast (Buckless and Ravenscroft 1990) of cell means and
assign a contrast weight of +1 to the no clarify/no CAM condition and a contrast weight of -1 to
the clarify/no CAM condition. We find that jurors’ evaluations of auditors’ negligence likelihood
are significantly lower when the audit report clarifies what is meant by auditors’ responsibility to
provide reasonable assurance (mean = 4.63) relative to when such clarification is absent (mean =
5.52, F\(_{1,236}\) = 3.38, one-tailed p = 0.034). Analysis of jurors’ binary verdict decision yields

\(^\text{15}\) We calculated Hosmer and Lemeshow’s Chi-square to assess whether our estimated logistic regression model fit
the data sufficiently for statistical inference. Results of this test statistic (\(\chi^2 = 3.454, \text{ df} = 4, p = 0.485\)) indicate “good
fit”.
similar results. The inclusion of language that clarifies the meaning of reasonable assurance significantly decreases the odds that the auditor will be found negligent (mean = 61% vs. mean = 37%; $\chi^2_{1} = 4.33$, one-tailed p = 0.019). Thus, H1 is supported.

Our theory for H1 argues that clarifying what is meant by reasonable assurance highlights the limitations imposed by the auditing standards on auditors’ responsibilities for detecting and correcting all material misstatements. We argue that awareness of this limited responsibility enables jurors to discount the role of auditors’ actions in causing the misstated financials, leading to lower evaluations of auditors’ negligence likelihood. Consistent with our theory, jurors exposed to audit reports that clarify the term reasonable assurance perceive auditors as having less causal control over the adverse outcome (mean = 4.21) than when the audit report includes no such clarification (mean = 6.35). The predicted mediating relationship is demonstrated by the following regression results (Baron and Kenny 1986):

1) The inclusion of clarifying language in the audit report influences jurors’ assessments of auditors’ causal control over the misstatement ($b = -2.14$, one-tailed p < 0.001),

2) Jurors’ assessments of auditors’ causal control over the misstatement influences their evaluations of auditors’ negligence likelihood ($b = 0.45$, one-tailed p < 0.001), and

3) Inclusion of jurors’ assessments of auditors’ causal control over the misstatement eliminates the effect of including clarifying language in the audit report ($b = 0.08$, one-tailed p = 0.433 when the mediator is included versus $b = -0.90$, one-tailed p = 0.034 when the mediator is not included in the regression).

Thus, consistent with the Culpable Control Model, jurors’ assessments of auditors’ causal control over the misstatement mediates the relationship between clarifying the limitations of reasonable assurance and jurors’ evaluations of auditor negligence.

**Test of H2**

H2 predicts that when the audit report contains a critical audit matter paragraph, jurors will assess a higher likelihood that the audit firm is negligent compared to assessments made
based on the standard audit report. To test H2, we assign a contrast weight of -2 to the no clarify/no CAM condition, +1 when to the no clarify/CAM condition, and +1 to the no clarify/CAM with procedures condition. Combining the two CAM paragraph conditions is appropriate because the study’s theory and hypotheses pertain to whether the auditors disclose the audit procedures performed on the critical audit area as opposed to the extent of the information disclosed.

As hypothesized, jurors in the no clarify/no CAM condition assessed lower levels of auditor negligence likelihood (mean = 5.52) than those jurors in the two conditions where a CAM paragraph is included in the audit report (mean = 5.95). However, our planned contrast is not significant ($F_{1,236} = 1.07$, one-tailed $p = 0.151$). We also do not find support for the planned contrast using jurors’ binary verdict decisions (mean = 61% vs. mean = 69%, $\chi^2_{1} = 0.88$, one-tailed $p = 0.174$). Further analysis reveals, though, that different levels of auditor disclosure within the CAM paragraph do affect jurors’ assessments of auditor liability. In particular, simply identifying a critical audit matter does not significantly change auditors’ negligence likelihood compared to the standard audit report (mean = 5.50 vs. mean = 5.52, $F_{1,236} = 1.24$, one-tailed $p = 0.479$). However, jurors are more likely to find the audit firm negligent when the audit report also includes a description of the specific audit procedures performed to address the identified critical audit matter (mean = 6.38) compared to both the standard audit report (mean = 5.52 $F_{1,236} = 3.45$, one-tailed $p = 0.032$) and the audit report that only identifies the critical audit matter (mean = 5.50, $F_{1,236} = 3.70$, one-tailed $p = 0.028$). Taken together, these results suggest that there may be unintentional costs in the form of increased auditor liability associated with expanded disclosures of critical audit matters in the audit report. We further explore how different levels of
auditor disclosure affect jurors’ assessments of auditor liability in the Additional Analyses section below.

Our theory for H2 argues that jurors perceive the critical audit matters highlighted in the audit report as having a higher likelihood of a material misstatement. Consequently, jurors view a misstatement associated with one of the reported matters as more foreseeable at the time of the audit, leading to higher evaluations of auditors’ negligence likelihood. Consistent with our theory, jurors perceive the misstatement as more foreseeable when the audit report emphasizes the critical audit matter that was ultimately misstated (mean = 6.18) compared to when the report is silent with respect to such matters (mean = 5.29). The predicted mediating relationship is demonstrated by the following regression results (Baron and Kenny 1986):

1) Emphasizing a critical audit matter in the audit report influences jurors’ assessments of the foreseeability of a misstatement (b = 1.14, one-tailed p < 0.000),

2) Jurors’ assessments of the foreseeability of a misstatement influences their evaluations of auditors’ negligence likelihood (b = 0.31, one-tailed p < 0.000), and

3) Inclusion of jurors’ assessments of the foreseeability of a misstatement eliminates the effect of emphasizing a critical audit matter in the audit report (b = 0.10, one-tailed p = 0.344 when the mediator is included versus b = 0.43, one-tailed p = 0.031 when the mediator is not included in the regression).

Thus, consistent with the Culpable Control Model, jurors’ assessments of the foreseeability of the misstatement mediates the relationship between emphasizing a critical audit matter in the audit report and jurors’ assessments of auditor negligence.

**Test of H3**

While we find evidence that clarifying what is meant by reasonable assurance in the audit report lowers jurors’ evaluations of auditor negligence (H1) and disclosing more audit-specific information about the emphasized critical audit matter tends to evoke more severe assessments of auditor negligence liability (H2), H3 formally predicts that clarifying the limitations of
reasonable assurance will diminish the negative consequences of providing an expanded critical audit matter paragraph in the audit report. To test this hypothesis, we assign contrast weights of 0 to the two conditions where there is no critical audit matter paragraph, +1 to the two CAM paragraph conditions when there is no clarifying language, and -1 to the two CAM paragraph conditions that include clarification of the limitations of reasonable assurance. Test results confirm that while inclusion of a CAM paragraph increases the severity of participants’ negligence assessments, clarifying the term reasonable assurance effectively reduces the severity of those assessments ($F_{1, 236} = 7.43$, one-tailed $p = 0.004$). Consistent results are found when analyzing jurors’ binary negligence verdicts ($\chi^2_{1} = 10.62$, one-tailed $p = 0.001$). Thus, H3 is also supported.

Further analysis suggests that the degree of benefit from including clarifying language in the audit report depends on the level of disclosure within the critical audit matter paragraph. When the audit report simply identifies a critical audit matter, clarifying what is meant by reasonable assurance does not significantly change jurors’ evaluations of auditor negligence compared to when no such clarification is offered (mean = 5.41 vs. mean = 5.50, $F_{1, 236} = 0.04$, one-tailed $p = 0.422$). However, clarifying the limitations of reasonable assurance significantly reduces auditors’ negligence likelihood assessments when the CAM paragraph also describes the audit procedures designed to address the key area (mean = 4.68 vs. mean = 6.38, $F_{1, 236} = 14.03$, one-tailed $p < 0.001$). Thus, clarifying what is meant by reasonable assurance most benefits auditors when the audit report contains more audit-specific information.

**Additional Analyses**

In an effort to understand how different levels of auditor disclosure affect jurors’ decision making, we first examine jurors’ expected level of assurance provided by the audit firm.
Consistent with H1, jurors in the CAM condition perceive auditors as being responsible for providing a lower level of assurance on the financial statements when the audit report clarifies the meaning of reasonable assurance (mean = 6.19) than when no such clarification is provided (mean = 7.87, F1, 236 = 17.42, one-tailed p < 0.001). The same is true when the critical audit matter paragraph includes a description of the audit procedures performed to address the critical audit matter (mean = 5.96 vs. mean = 7.98, F1, 236 = 27.92, one-tailed p < 0.001). Thus, clarifying the limitations of reasonable assurance lowers jurors’ expectations of auditors detecting and correcting all material misstatements regardless of the amount of audit-specific information provided in the audit report.

Analysis of the intensity of jurors’ counterfactual thinking and their perceptions of the foreseeability of the misstatement provides more insight into how jurors are affected by varying levels of public disclosure of audit-specific information. When the audit report includes the expanded CAM paragraph describing the audit procedures performed to address the critical audit matter, the intensity of jurors’ counterfactual thoughts (mean = 7.78 vs. mean = 7.09, F1, 236 = 3.00, one-tailed p = 0.043) and jurors’ perceptions of the foreseeability of the misstatement (mean = 7.20 vs. mean = 5.69, F1, 236 = 9.87, one-tailed p = 0.001) are significantly less when the audit report clarifies the meaning of reasonable assurance than when no such clarification is provided. However, no such reduction in counterfactual thinking (mean = 7.62 vs. mean = 7.42, F1, 236 = 0.23, one tailed p = 0.316) or perceived foreseeability of the misstatement (mean = 6.14 vs. mean = 5.62, F1, 236 = 1.07, one tailed p = 0.151) results from the inclusion of clarifying language when the CAM paragraph is silent as to the audit procedures.

Taken together, these analyses suggest that the benefit provided by lowering jurors’ expectations regarding auditors’ responsibility to detect and correct all material misstatements
when the audit report includes a critical audit matter paragraph depends on the extent to which audit-specific information is disclosed in the audit report. As noted above, we find that clarifying the limitations of reasonable assurance lowers jurors’ expectations about whether material misstatements will be detected in both CAM conditions. Consequently, when jurors have a lower benchmark against which they are evaluating auditors’ work, we find that jurors have less intense thoughts about what the audit firm should have done differently and perceive the misstatement as less foreseeable when the audit report includes a description of the work performed to address the identified critical audit matter. Therefore, jurors are less likely to find auditors liable when the audit report clarifies the limitations of reasonable assurance and provides an expanded CAM paragraph than when no such clarification is provided. However, when only the critical audit matter is identified without an accompanying description of the work performed surrounding this matter, a lower benchmark does not significantly reduce the intensity of jurors’ counterfactual thinking, their perceptions of the foreseeability of the misstatement, or their evaluations of auditor negligence when the audit report only identifies the critical audit matter.

V. CONCLUSION

In order to address the widespread concerns about the audit report’s communicative value, the PCAOB and IAASB are considering a number of potential changes to the report’s content and form (PCAOB 2011b; PCAOB 2013a; IAASB 2013). Practitioners and scholars, however, acknowledge that changes to the report could affect auditors’ liability exposure (Brasel et al. 2014; Katz 2014). This study contributes to our understanding of the implications of these changes by examining how two potential changes to the report’s content and form affect jurors’ evaluations of auditor negligence. Specifically, we examine how clarifying the meaning of
reasonable assurance in the public audit report alters jurors’ expectations of auditors and affects their perceptions of auditors’ causal control over the misstatement. We also investigate how the inclusion of, and amount of disclosure within, a critical audit matter paragraph changes jurors’ perceptions of the foreseeability of the misstatement.

Our results provide three general findings. Specifically, when a misstatement goes undetected, jurors are less likely to find auditors negligent when the audit report clarifies the meaning of reasonable assurance. However, auditors face a higher negligence likelihood when the audit report identifies and discloses the procedures performed to address an audit-specific critical audit matter related to the undetected misstatement. Contrary to auditors’ concerns, though, simply identifying the critical audit matter does not significantly increase auditors’ litigation risk. Finally, we find that clarifying what is meant by reasonable assurance effectively mitigates the negative unintended consequences of including an expanded critical audit matter paragraph in the audit report.

This study makes several contributions to both practice and research. First, we extend the auditor negligence literature, as well as inform practice and standard setters, by providing insight into how the proposed changes affect jurors’ decision making and auditors’ ability to defend their work. In particular, we find that clarifying language benefits auditors by reducing jurors’ perception of auditors’ causal control over the adverse outcome, while expanded critical audit matter paragraphs increase auditors’ litigation exposure by increasing jurors’ perceptions of the foreseeability of the misstatement. Second, this study provides evidence that addresses auditors’ concerns about increased litigation exposure associated with more detailed disclosures of critical audit matters in the audit report. However, our results also indicate that clarifying the meaning of reasonable assurance offers a noninvasive way to offset the negative impact of critical audit
matter paragraphs on auditor litigation risk. Finally, our study contributes to the prior auditing literature examining the persistence of the expectations gap by providing evidence that clarifying the limitations of reasonable assurance in the audit report effectively reduces jurors’ expectations.
APPENDIX A

Exhibit 1
Smith & Company
Audit Report

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Shareholders
Internet-4-All, Inc.:  

We have audited the accompanying financial statements of Internet-4-All (the Company), which are comprised of the balance sheet as of December 31, 2012, and the related statements of income, shareholders’ equity, and cash flows for the year then ended, and the related notes to the financial statements. The Company’s management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with the 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 from material misstatement. [Clarifying Language condition: Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable assurance that material misstatements are detected. Reasonable assurance is a high level of assurance, but not absolute. Therefore, an audit conducted in accordance with generally accepted auditing standards may not detect a material misstatement.] Our audit of the financial statements included performing procedures designed to obtain and evaluate, on a test basis, evidence supporting the amounts and disclosures of the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. Accordingly, we express no such opinion. Our audit also included assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Internet-4-All as of December 31, 2012, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[Emphasis and Emphasis with Procedures conditions:]

Justification of Auditor Assessments

In accordance with the professional standards applicable in the United States, we are required to bring to your attention any critical audit matters. Critical audit matters are matters (1) that involved difficult, subjective or complex judgments, (2) for which it was difficult to obtain sufficient audit evidence, or (3) that posed difficulty to us in forming our opinion on the financial statement. The critical audit matter communicated below did not alter our opinion on the financial statements, taken as a whole.

As discussed in Note 1, Significant Accounting Policies, the Company elected to value its ending inventory at cost, rather than market value. Our audit included procedures designed to evaluate the risk of material misstatement associated with management’s valuation of ending inventory at cost rather than market value. [Emphasis with Procedures condition only: Specifically, we tested the Company’s procedures for identifying obsolete inventory, considered changes in the inventory turnover rate, and analyzed the facts available at the time of the audit to determine if the market value of the inventory was lower than cost.] Based on the procedures performed and our analysis of the facts available at the time of the audit, we conclude that the Company’s inventory valuation is reasonable and that the related risk of material misstatement is insignificant to the financial statements as a whole.

/s/ Smith and Company

New York, New York

February 21, 2013

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REFERENCES


American Institute of Certified Public Accountants (AICPA). 1995. Amendment to statement on auditing standards no. 58, Reports on audited financial statements. Available at: http://umiss.lib.olemiss.edu:82/articles/1038106.6706/1.PDF.


Indirect Spontaneous Reaction to the Auditors refers to jurors’ spontaneous affective reactions to the favorability or unfavorability of the auditors. These affective reactions indirectly influence jurors’ evaluations of auditor negligence by shifting jurors’ perceptions of the key determinants of auditors’ personal control.

Causation refers to jurors’ perceptions of the auditors’ causal control over the adverse outcome stemming from the misstated financial statements.

Foreseeability refers to jurors’ perceptions of the foreseeableness of the misstatement given the facts available at the time of the audit.

Intention refers to jurors’ perceptions of the auditors’ intentions to conduct a quality risk-based audit.

Direct Spontaneous Reaction to the Case refers to jurors’ affective reactions to the case that have a direct influence on jurors’ evaluations of auditor negligence.

Jurors’ Evaluations of Auditor Negligence refers to the factor score calculated from jurors’ assessments of the auditors’ blameworthiness and negligence.
### TABLE 1

**Means (Standard Errors) by Treatment**

<table>
<thead>
<tr>
<th></th>
<th>No Clarify</th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No CAM</td>
<td>CAM</td>
<td>CAM with Procedures</td>
<td>Combined</td>
</tr>
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<td>n=41 n=42 n=43 n=85 n=126</td>
<td>n=41 n=42 n=43 n=85 n=126</td>
<td>n=41 n=42 n=43 n=85 n=126</td>
<td>n=41 n=42 n=43 n=85 n=126</td>
<td>n=41 n=42 n=43 n=85 n=126</td>
</tr>
<tr>
<td>Negligence Likelihood</td>
<td>5.52 (0.34)</td>
<td>5.50 (0.37)</td>
<td>6.38 (0.26)</td>
<td>5.95 (0.23)</td>
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<td></td>
<td>4.63 (0.34)</td>
<td>5.41 (0.38)</td>
<td>4.68 (0.31)</td>
<td>5.01 (0.24)</td>
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<td></td>
<td>5.11 (0.25)</td>
<td>5.46 (0.26)</td>
<td>5.52 (0.22)</td>
<td>5.49 (0.17)</td>
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<tr>
<td>Negligence Verdict</td>
<td>0.61 (0.08)</td>
<td>0.67 (0.07)</td>
<td>0.72 (0.07)</td>
<td>0.69 (0.05)</td>
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<td></td>
<td>0.37 (0.08)</td>
<td>0.59 (0.08)</td>
<td>0.45 (0.08)</td>
<td>0.52 (0.06)</td>
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<td></td>
<td>0.50 (0.06)</td>
<td>0.63 (0.06)</td>
<td>0.59 (0.05)</td>
<td>0.61 (0.04)</td>
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<td>Assurance Provided</td>
<td>6.60 (0.27)</td>
<td>7.87 (0.27)</td>
<td>7.98 (0.22)</td>
<td>7.92 (0.17)</td>
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<td>5.79 (0.27)</td>
<td>6.19 (0.41)</td>
<td>5.96 (0.25)</td>
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<td>6.22 (0.19)</td>
<td>7.08 (0.25)</td>
<td>6.95 (0.20)</td>
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<td>Discussion of CAM in Report</td>
<td>4.82 (0.25)</td>
<td>5.13 (0.33)</td>
<td>5.34 (0.35)</td>
<td>5.24 (0.24)</td>
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<td></td>
<td>4.83 (0.39)</td>
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<td>5.68 (0.22)</td>
<td>5.75 (0.19)</td>
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<td></td>
<td>4.82 (0.22)</td>
<td>5.46 (0.23)</td>
<td>5.51 (0.21)</td>
<td>5.49 (0.16)</td>
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<td>Causal Control</td>
<td>6.35 (0.37)</td>
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<td>5.98 (0.31)</td>
<td>5.88 (0.23)</td>
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<td></td>
<td>4.21 (0.41)</td>
<td>4.80 (0.40)</td>
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<td>5.37 (0.30)</td>
<td>5.32 (0.27)</td>
<td>5.12 (0.26)</td>
<td>5.22 (0.19)</td>
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<td>Foreseeability of Misstatement</td>
<td>4.93 (0.04)</td>
<td>6.14 (0.38)</td>
<td>7.20 (0.27)</td>
<td>6.68 (0.24)</td>
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<td></td>
<td>5.71 (0.40)</td>
<td>5.62 (0.40)</td>
<td>5.69 (0.32)</td>
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<td>5.29 (0.27)</td>
<td>5.90 (0.27)</td>
<td>6.44 (0.22)</td>
<td>6.18 (0.18)</td>
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<td>Counterfactual Intensity</td>
<td>6.63 (0.36)</td>
<td>7.62 (0.29)</td>
<td>7.78 (0.25)</td>
<td>7.70 (0.19)</td>
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<td></td>
<td>7.23 (0.35)</td>
<td>7.42 (0.29)</td>
<td>7.09 (0.22)</td>
<td>7.24 (0.18)</td>
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<tr>
<td></td>
<td>6.91 (0.25)</td>
<td>7.53 (0.20)</td>
<td>7.43 (0.17)</td>
<td>7.48 (0.13)</td>
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</table>

Negligence likelihood is jurors' likelihood assessment of whether the audit firm was negligent on a scale from 0 = Not at all likely to 10 = Extremely likely.  
Negligence verdict is jurors' binary verdict decision where 0 = Not negligent and 1 = Negligent.  
Assurance provided captures jurors' perceptions about the level of assurance that auditors are required to provide on a scale from 0 = No assurance to 10 = Absolute assurance.  
Discussion of CAM in report is jurors' rating of how much the audit firm discussed the critical audit matter in the audit report on a scale from 0 = No discussion to 10 = A lot of discussion.  
Causal control captures jurors' perceptions of auditors' causal control over the adverse outcome on a scale from 0 = Not at all the cause to 10 = Completely the cause.  
Foreseeability of misstatement captures jurors' perceptions of the foreseeability of the misstatement given the facts available at the time of the audit on a scale from 0 = Not at all foreseeable to 10 = Completely foreseeable.  
Counterfactual intensity refers to how seriously jurors thought about what the audit firm could have done differently on a scale from 0 = Not at all seriously to 10 = Very seriously.
**TABLE 2**

Jurors’ Evaluations of Negligence Likelihood

**Panel A: Two-Way ANOVA Results for Negligence Likelihood**

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>MS</th>
<th>F</th>
<th>two-tailed p-value</th>
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<tbody>
<tr>
<td>Clarify</td>
<td>1</td>
<td>48.39</td>
<td>10.78</td>
<td>0.001</td>
</tr>
<tr>
<td>CAM</td>
<td>2</td>
<td>4.67</td>
<td>1.04</td>
<td>0.355</td>
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<tr>
<td>Clarify*CAM</td>
<td>2</td>
<td>13.35</td>
<td>2.97</td>
<td>0.053</td>
</tr>
<tr>
<td>Error</td>
<td>236</td>
<td></td>
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</tbody>
</table>

*Clarify* is the treatment variable manipulated at two levels (*No Clarify, Clarify*)

*CAM* is the treatment variable manipulated at three levels (*No CAM, CAM, CAM with Procedures*)

*Negligence verdict* is jurors’ binary verdict decision where 0 = Not negligent and 1 = Negligent

Combined CAM represents a pooling of the *CAM* and *CAM with Procedures* conditions.

**Panel B: Tests of Hypotheses**

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>F&lt;sub&gt;1,236&lt;/sub&gt;</th>
<th>one-tailed p-value</th>
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<tbody>
<tr>
<td>H1: <em>No Clarify/No CAM &gt; Clarify/No CAM</em></td>
<td>3.38</td>
<td>0.034</td>
</tr>
<tr>
<td>H2: <em>No Clarify/No CAM &lt; (No Clarify/CAM + No Clarify/CAM with Procedures)/2</em></td>
<td>1.07</td>
<td>0.151</td>
</tr>
<tr>
<td>H3: (No Clarify/CAM + No Clarify/CAM with Procedures)/2 &gt; (Clarify/CAM + Clarify/CAM with Procedures)/2*</td>
<td>7.43</td>
<td>0.004</td>
</tr>
</tbody>
</table>
TABLE 3

Jurors’ Negligence Verdicts

Panel A: General Linear Model (Logit Link, Binomial Distribution) for Juror Verdicts

<table>
<thead>
<tr>
<th>Source of Variation</th>
<th>df</th>
<th>$\chi^2$</th>
<th>two-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Clarify</td>
<td>1</td>
<td>8.95</td>
<td>0.003</td>
</tr>
<tr>
<td>CAM</td>
<td>2</td>
<td>3.22</td>
<td>0.200</td>
</tr>
<tr>
<td>Clarify*CAM</td>
<td>2</td>
<td>1.76</td>
<td>0.416</td>
</tr>
</tbody>
</table>

Panel B: Tests of Hypotheses

<table>
<thead>
<tr>
<th>Planned Contrasts</th>
<th>$\chi^2$</th>
<th>one-tailed p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>H1: No Clarify/No CAM &gt; Clarify/No CAM</td>
<td>4.33</td>
<td>0.019</td>
</tr>
<tr>
<td>H2: No Clarify/No CAM &lt; (No Clarify/CAM + No Clarify/CAM with Procedures)/2</td>
<td>0.88</td>
<td>0.174</td>
</tr>
<tr>
<td>H3: (No Clarify/CAM + No Clarify/CAM with Procedures)/2 &gt; (Clarify/CAM + Clarify/CAM with Procedures)/2</td>
<td>10.62</td>
<td>0.001</td>
</tr>
</tbody>
</table>

*Clarify* is the treatment variable manipulated at two levels (*No Clarify, Clarify*)

*CAM* is the treatment variable manipulated at three levels (*No CAM, CAM, CAM with Procedures*)

*Negligence verdict* is jurors’ binary verdict decision where 0 = Not negligent and 1 = Negligent

Combined CAM represents a pooling of the CAM and CAM with Procedures conditions.