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The Importance of Clarification of Auditors' Responsibilities Under the New Audit Reporting Standards*

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ABSTRACT

Given the uncertainty regarding auditors' responsibilities, standard setters considered the need for clarification of technical terms such as reasonable assurance in the new audit reporting models. The PCAOB ultimately decided to exclude clarifying language from its final standard, while the Auditing Standards Board and IAASB made such language mandatory. Given the difference in reporting models, this study investigates the role clarification of reasonable assurance plays in auditor negligence. We predict and find that, absent clarification, jurors judge auditors to be more negligent when the audit report includes a related critical audit matters disclosure than when it does not. However, consistent with our prediction, clarifying what is meant by reasonable assurance mitigates this increase in auditors' liability exposure by reducing jurors' perceptions of auditors' personal control over the misstatement at the time of the audit. Thus, our evidence suggests that the PCAOB's decision to not include such language in the new audit reporting model may have been shortsighted given the potential for clarification to mitigate a potential negative unintended consequence to auditors' litigation exposure under the new audit reporting model.

Keywords: auditor liability, audit report, reasonable assurance, critical audit matter

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L'importance de la clarification des responsabilités des auditeurs dans le cadre des nouvelles normes de rapport d'audit

RÉSUMÉ

Compte tenu de l'incertitude concernant les responsabilités des auditeurs, les normalisateurs ont considéré la nécessité de clarifier des termes techniques tels que l'assurance raisonnable dans les nouveaux modèles de rapports d'audit. La Commission de surveillance de la comptabilité des sociétés cotées en bourse (PCAOB) a finalement décidé d'exclure le langage de clarification de sa norme finale, alors que l'Auditing Standards Board et le Conseil des normes internationales d'audit et d'assurance (IAASB) ont rendu ce langage obligatoire. Compte tenu de la différence entre les modèles de rapport, cette étude examine le rôle que joue la clarification de l'assurance raisonnable dans la négligence des auditeurs. Les auteurs émettent l'hypothèse et constatent que, en l'absence de clarification, les jurés considèrent les auditeurs comme étant plus négligents lorsque le rapport d'audit comprend une déclaration relative aux questions critiques de l'audit que lorsque le rapport n'en comprend pas. Cependant, conformément à leur prédiction, la clarification de ce que l'on entend par assurance raisonnable atténue cette augmentation de l'exposition des auditeurs à la responsabilité en réduisant les perceptions des jurés quant au contrôle personnel des auditeurs sur l'anomalie au moment de l'audit. Ainsi, la décision de la PCAOB de ne pas inclure un tel langage dans le nouveau modèle de rapport d'audit était sans doute limitée considérant le potentiel de clarification pour atténuer une conséquence négative involontaire potentielle sur l'exposition des auditeurs aux litiges dans le cadre du nouveau modèle de rapport d'audit.

Mots-clés : responsabilité de l'auditeur, rapport d'audit, assurance raisonnable, question critique de l'audit

1. Introduction

Auditing standards require auditors to provide reasonable assurance that the financial statements are free of material misstatements (AS 1015.10, PCAOB 2006). While absolute assurance is not possible given the nature of an audit, auditors are able to provide a high level of assurance through the exercise of due professional care (AS 1015.10, PCAOB 2006).

Unfortunately, jurors' expectations of the accounting profession far exceed the level of assurance required by the auditing standards (Frank et al. 2001), partially due to the lack of a commonly accepted definition of reasonable assurance (Hogan et al. 2008). This is concerning given that auditors' failure to meet jurors' expectations is cause for finding them negligent (Causey and Causey 1991). Our study addresses this concern by examining the extent to which the clarification of auditors' responsibilities per the auditing standards affects jurors' evaluations of auditors. Specifically, we investigate how clarifying the limitations of reasonable assurance affects jurors' assessments of auditor negligence under the new audit reporting model.

Our research question is important for three primary reasons. First, the ambiguity surrounding auditors' responsibilities has remained part of the larger debate over the audit report's usefulness for more than 30 years. One way to improve users' understanding of auditors' responsibilities as described in the auditing standards is to clarify the meaning of reasonable assurance. While jurors typically learn about the notion of reasonable assurance during the trial proceedings, we know very little about the extent to which such explanations affect jurors' expectations of auditors. Second, there is no mechanism in place during an actual trial to ensure that jurors are made aware of the inherent limitations of reasonable assurance as explained in the auditing standards. Explicitly referencing such limitations in the audit report is a simple way to ensure such knowledge is disseminated to all users and evaluators of the audited financial statements. However, it is an empirical question as to the impact that such clarification has on jurors' evaluations of auditors. Finally, despite support from the audit profession (PCAOB 2011a, 2011b, 2011c, 2011d, 2011e, 2017), the

PCAOB decided not to require clarification of technical terms such as reasonable assurance in the new audit reporting model. This is in contrast to the decisions of both the Auditing Standards Board (ASB) and the IAASB to require that every audit report explain the limitations of reasonable assurance, stating that it is a high level of assurance but does not guarantee that every material misstatement will be detected (AU-C 700 ¶35, AICPA 2019; ISA 700 ¶37b, IAASB 2015a). Consequently, it is important to understand the potential ramifications of the PCAOB's decision to exclude such language from the standard audit report.

While understanding the impact that clarification within the audit report has on jurors' evaluations of auditors is important, it is also important to consider how such clarification could impact auditors' litigation risk in light of recent changes to the audit reporting model. Standard setters across the globe recently mandated the disclosure of audit-specific critical audit matters (CAMs) in response to growing concerns about the usefulness of the audit report (ISA 701 ¶13(b), IAASB 2015b; PCAOB 2017). Recent research finds that in settings where CAMs are related to areas with measurement uncertainty (e.g., environmental restoration liability), auditors are not evaluated more harshly for an audit failure in an area related to the CAM disclosure included in the audit report (Brasel et al. 2016; Brown et al. 2020; Gimbar et al. 2016; Kachelmeier et al. 2020). However, Gimbar et al. (2016) and Kachelmeier et al. (2020) find that CAMs may actually increase auditors' litigation exposure, particularly in settings that are conducive to counterfactual thinking (e.g., classification decisions that invite and attract comparison) (Kachelmeier et al. 2020).

To examine our research question, we conduct an experiment using a 2×2 factorial design. Student participants assume the role of jurors in a case alleging auditor negligence adapted from Backof (2015). The audit failure stems from the audit firm's evaluation of management's lower-of-cost-or-market inventory valuation judgment, a setting conducive to counterfactual thinking. We manipulate *Clarifying Language* at two levels. In the Clarify condition, the audit report clarifies that audits conducted in accordance with generally accepted auditing standards may not detect a material misstatement because auditors are required to provide high, but not absolute, assurance. In the No Clarify condition, the report contains no such clarifying language. Our second independent variable, *CAM Disclosure*, is manipulated at two levels. By manipulating CAM disclosure presence or absence, we are able to test that we are in fact examining a setting where CAMs enhance counterfactual thinking and lead to harsher evaluations of auditors. In the No CAM condition, the audit report mimics the former standard unqualified audit report and does not include a CAM disclosure. Our CAM condition includes a paragraph in the audit report that highlights the risk of material misstatement in the valuation of the inventory account, why the auditors identified that risk as a CAM, and a description of the specific audit procedures performed by the audit firm to address the risk of material misstatement.

Overall, our results are consistent with our expectations regarding how clarification and CAM disclosures affect jurors' evaluations of auditors through the CAMs' effects on key determinants of auditors' perceived personal control over the adverse outcome (Alicke 2000; Backof 2015) and the intensity of jurors' counterfactual thinking (Reffett 2010). We predict and find that clarification of what is meant by reasonable assurance offers auditors some litigation protection by significantly lowering jurors' expectations of auditors and their perceptions of auditors' personal control over the adverse outcome. Absent clarification, though, in settings conducive to counterfactual thinking, jurors perceive auditors as more negligent when the audit report includes a CAM disclosure related to the undetected misstatement compared to when such a disclosure is missing. Evidence supports our prediction that this is because jurors engage in more intense counterfactual reasoning and perceive the undetected misstatement as being more foreseeable to the auditor at the time of the audit when a related CAM disclosure is included in the audit report. Finally, by reducing jurors' perceptions of auditors' personal control over the adverse outcome, clarifying language effectively moderates the negative effect that CAMs have on the intensity of

jurors' counterfactual thinking. Thus, we find that one way to mitigate this potentially higher litigation risk associated with the newly required CAM disclosures is to clarify the limitations of reasonable assurance in the audit report.

This study contributes to both practice and research in important ways. First, we contribute to the overall auditor negligence literature by demonstrating how clarifying a key technical term used to describe auditors' responsibilities affects jurors' evaluations of auditors. In particular, we find that clarifying what is meant by reasonable assurance reduces auditors' litigation exposure by significantly lowering jurors' expectations of auditors' responsibilities and their perceptions of auditors' personal control over the adverse outcome. Thus, our findings suggest that assurance clarification has the potential to mitigate auditors' heightened litigation exposure in other settings, including when auditors are operating under imprecise accounting standards (Kadous and Mercer 2012, 2016) and when auditors investigate for fraud but fail to detect it (Reffett 2010).

Second, it is important to examine the ramifications of the recent changes to the audit reporting model and how to mitigate any unintended consequences of such changes. Like Gimbar et al. (2016) and Kachelmeier et al. (2020), we identify a setting under which CAMs may actually increase auditors' litigation exposure. In particular, in an inventory valuation setting conducive to counterfactual thinking, we show that auditors disclosing a related CAM face a higher litigation risk than auditors who make no such disclosure when the limitations of reasonable assurance are not clarified. However, we find that clarification effectively mitigates the increase in auditors' liability exposure associated with the CAM disclosure. Thus, we advance the argument raised by Kachelmeier et al. (2020) that the nature of the CAM is critical to evaluating its potential effect on auditor litigation exposure. In particular, in a setting where CAMs are most likely to increase jurors' assessments of auditors' negligence likelihood, we identify an externally valid intervention that is capable of reducing auditors' litigation exposure through its effect on jurors' perceptions of auditors' personal control over the adverse outcome.

Finally, our evidence collectively suggests that the PCAOB's decision not to include such language in the new audit reporting model may have been shortsighted given the role that clarification of the term reasonable assurance could play in managing auditors' litigation exposure under the new audit reporting model. Our findings are particularly relevant to audit firms with clients that are cross-listed on multiple exchanges and, thus, must simultaneously issue separate audit reports prepared in accordance with the PCAOB and IAASB standards. Both of these audit reports accompany the clients' financial statements in their annual reports to shareholders, and, thus, are equivalently accessible to users of the financial statements.¹ While our results suggest that auditors issuing an audit report in accordance with PCAOB standards may be exposed to a higher litigation risk in the event of an adverse outcome associated with a previously identified CAM, there might be an advantage to issuing two audit reports simultaneously on the same set of financial statements given that the clarifying language included in the IAASB audit report will likely mitigate the heightened litigation risk associated with the CAM disclosure.

2. Background, theory, and hypothesis development

Assurance clarification in the standard audit report

The audit report is the primary means by which auditors communicate information to external users of the financial statements.² Critics of the old audit reporting model frequently cited users' uncertainty regarding auditors' responsibilities as a limitation to the report's communicative value

1. For example, Royal Bank of Canada (RBC) is cross-listed on the Toronto Stock Exchange and the NYSE. PricewaterhouseCoopers LLP issued two separate audit opinions for the RBC's 2020 annual report: one in accordance with PCAOB standards and one in accordance with IAASB standards (RBC 2020).
2. According to former PCAOB 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).

(Asare and Wright 2012; Carcello 2012; Mock et al. 2013). Given the uncertainty regarding auditors' responsibilities, standard setters considered the need to clarify technical terms such as reasonable assurance in the new audit reporting models. The IAASB and ASB both require that a description of reasonable assurance and its limitations be included in every audit report (AU-C 700 ¶35, AICPA 2019; ISA 700 ¶37b, IAASB 2015a). In contrast, the PCAOB ultimately decided to exclude such language from its final standard (PCAOB 2017) after determining that "commenters generally did not support adding additional language to the auditor's report that would further explain the term 'reasonable assurance.'" (PCAOB 2013, 26). Contrary to this statement, though, the Center for Audit Quality (PCAOB 2011a), all of the Big 4 accounting firms (PCAOB 2011b, 2011c, 2011d, 2011e), and many other large accounting firms (PCAOB 2011f, 2011g, 2011h, 2011i, 2016a) explicitly supported clarifying what is meant by reasonable assurance in the new audit reporting model. Therefore, it is important to explore how this difference in PCAOB and IAASB audit reports affects perceptions of auditors' responsibilities and evaluations of their actions.

Critical audit matter disclosures in the standard audit report

While standard setters disagreed about the importance of clarifying reasonable assurance in the audit report, they did agree on the need for mandatory disclosure of audit-specific CAMs (ISA 701 ¶13(b), IAASB 2015b; PCAOB 2017).³ By providing audit-specific information in the audit report, CAM disclosures directly address concerns about the lack of information specific to an individual audit in the audit report (Asare and Wright 2012; Church et al. 2008). However, concerns regarding unforeseen costs, including heightened litigation risk associated with the disclosure of audit-specific matters of greatest concern (PCAOB 2011b, 2011c, 2011d, 2011e), prompted numerous studies investigating how audit-specific CAM disclosures influence auditors' litigation exposure (Brasel et al. 2016; Brown et al. 2020; Gimbar et al. 2016; Kachelmeier et al. 2020).

Prior research provides important insights into the effect of CAM disclosures on auditors' litigation exposure. Kachelmeier et al. (2020) posit and present evidence that suggests the seemingly differential findings reported in prior CAM research (cf. Brasel et al. 2016; Gimbar et al. 2016) may be driven by whether or not the misstatement setting is conducive to counterfactual reasoning. When a CAM is related to an account with high measurement uncertainty (e.g., an understatement of an environmental restoration liability), misstatements in that account are relatively difficult for the plaintiff to foresee. Thus, CAM disclosures are perceived as a forewarning to the users of the financial statements regarding the heightened risk of material misstatement in the account, leading to less harsh evaluations of auditors (Brasel et al. 2016). When the CAM is related to a misstatement that is conducive to counterfactual reasoning (e.g., operating vs. capital lease classification, cost vs. market inventory valuation), though, the mitigating effect of a forewarning associated with a CAM disclosure is diminished (Kachelmeier et al. 2020). For example, in a lease classification setting where the adverse outcome is driven by a categorical error, Gimbar et al. (2016) find evidence that is consistent with CAMs facilitating counterfactual thinking and, thus, increasing auditors' liability. Our study extends this line of research by examining the role clarification plays in mitigating auditors' heightened litigation risk associated with CAM disclosures in settings conducive to counterfactual thinking.⁴

3. Standards applicable to non-issuers in the United States do not require the communication of critical (or key) audit matters but do allow them when the auditor is engaged to provide such communications (AICPA 2019).

4. Gimbar et al. (2016) find that CAM disclosures increase jurors' beliefs that the misstatement was foreseeable to the auditor at the time of the audit. This increase in their perceptions of foreseeability to the auditor then leads to higher assessments of negligence likelihood. On the other hand, Brasel et al. (2016) find that CAMs lead to higher assessments of foreseeability to the plaintiff. This, in turn, results in jurors assessing a lower negligence likelihood. Thus, it is possible that the framing of the foreseeability measure affects jurors' attributions of blame toward the auditor and is thus one, but not the only, reason for the mixed results. However, Kachelmeier et al. (2020) present evidence that these disparate findings can be attributed to whether or not the setting is conducive to counterfactual thinking.

Jurors' evaluations of auditors

We know from prior research that jurors' evaluations of auditors are influenced by their perceptions of whether or not auditors met their expectations (Causey and Causey 1991), the intensity of their counterfactual thoughts (Reffett 2010), and their perceptions of auditors' personal control over the adverse outcome (Backof 2015). First, jurors' expectations of the required level of assurance on any given audit are particularly important when determining auditor negligence. Per the auditing standards, auditors have a duty to provide reasonable assurance about whether the financial statements are free of material misstatement (AS 1015.10, PCAOB 2006). A breach of this duty is cause for finding the audit firm to be negligent (Causey and Causey 1991). Consequently, jurors' expectations regarding auditors' responsibility for detecting and correcting misstatements serve as the benchmark against which auditors' actions are evaluated when assessing negligence.

Second, jurors engage in counterfactual thinking when they imagine how prior outcomes could have been avoided (Alicke et al. 2008). Prior research finds that jurors' assessments of the defendant's (i.e., auditor's) negligence likelihood increase with the intensity of these counterfactual thoughts (Miller and McFarland 1986; Bothwell and Duhon 1994; Reffett 2010). Finally, the culpable control model (CCM) (Alicke 2000) extends what we know about the effect of counterfactual reasoning by identifying conditions under which counterfactual reasoning increases jurors' blame assessments. According to the CCM, counterfactual reasoning will only increase assessments of blame when evaluators perceive the actor had control over an adverse outcome and did not take appropriate precautions to prevent its occurrence (Alicke et al. 2008). We draw on the collective insights gained from this prior research examining jurors' decision-making to theorize how recent changes to the audit reporting model affect jurors' evaluations of auditors.

Starting with clarification, we argue that clarifying auditors' responsibilities may benefit auditors by lowering jurors' expectations of auditors and their perceptions of auditors' personal control over the adverse outcome. The audit report is the medium through which the audit firm affirms that it has provided the required level of assurance to users of the financial statements. The lack of a commonly accepted definition of reasonable assurance (Hogan et al. 2008), though, suggests the need to clarify that reasonable assurance is a high, but not absolute, level of assurance. We posit that such explicit clarification in the audit report has the potential to decrease jurors' expectations of the level of assurance auditors are required to provide, thereby benefiting auditors by lowering the benchmark against which auditors' actions are evaluated when assessing negligence. Importantly, we expect that these lower expectations will also impact jurors' perceptions of auditors' personal control over the adverse outcome.

Perceived personal control is a function of jurors' perceptions of the audit firm's intentions to provide a high-quality audit, their causal control defined as auditors' control over the process by which behaviors produce harmful outcomes, and the foreseeability of the adverse outcome to the audit firm at the time of the audit (Alicke 2000; Backof 2015). The auditing standards explain that undetected material misstatements are an inherent limitation of an audit conducted in accordance with the standards because absolute assurance is not attainable (AS 1015.10, PCAOB 2006). Hence, an undetected misstatement could be attributed to perceived shortcomings in the standards rather than the quality of the audit provided. Evaluators, though, discount the causal role one plays in an outcome when there are other plausible causes present (Kelly 1973). Consequently, we argue that jurors will likely discount auditors' causal control, or auditors' ability to control the outcome, over the misstated financial statements when they realize that the level of assurance required by the auditing standards allows for material misstatements to potentially go undetected. This is important because Backof (2015) finds that as jurors' perceptions of causal control increase, so do their perceptions of auditors' personal control and auditors' liability.

While not all CAM disclosures pose a threat to auditors, auditors do face a higher litigation risk following an audit failure when the audit report includes a CAM that facilitates

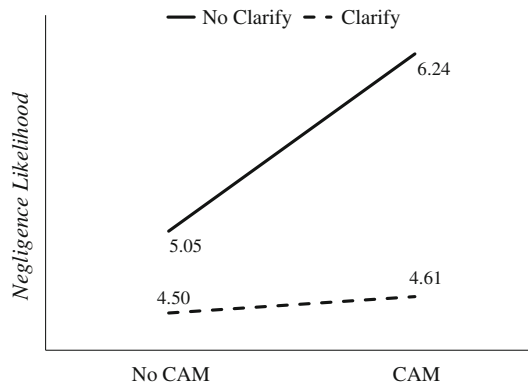
counterfactual thinking (Gimbar et al. 2016). We know from prior research that the closeness of the outcome (Kahneman and Miller 1986) and mutability of the prior event (Creyer and Gürhan 1997) both affect the extent to which evaluators engage in counterfactual reasoning. In particular, these prior studies find that near misses and actions taken by the focal actor to prevent the adverse prior event lead to more intense counterfactual thoughts as it is easier to imagine specific circumstances or changes in behavior that would have altered the outcome in question. However, as Kachelmeier et al. (2020) note, categorical determinations (e.g., operating vs. capital lease classification, cost vs. market inventory valuation) attract and invite comparison. When the outcome suggests that the auditors chose the incorrect category, categorical determinations allow for counterfactual reasoning whereby the chosen alternative is negatively evaluated against the unchosen alternative (Medvec and Savitsky 1997). Thus, we expect the inclusion of a CAM disclosure related to a categorical determination to lead jurors to engage in more intense counterfactual thinking than when such a disclosure is absent from the audit report.

Furthermore, Gimbar et al. (2016) posit that these counterfactual thoughts prompted by such CAM disclosures may affect jurors' perceptions regarding what the auditor should have been able to foresee in the acknowledged critical area at the time of the audit. The purpose of a CAM disclosure is to communicate to financial statement users the specific areas of the audit that required significant auditor judgment or that posed the most difficulty to the auditors (PCAOB 2016b). As such, CAM disclosures serve as evidence of auditors' awareness of the heightened risk of material misstatement in a particular area at the time of the audit (Katz 2014). This heightened awareness combined with the intense counterfactual reasoning regarding the categorical determination that ultimately led to the audit failure, in turn, is likely to increase jurors' perceptions regarding the foreseeability of the adverse outcome to the auditor (Gimbar et al. 2016). This is important because jurors' perceptions of the foreseeability of the misstatement to the auditor at the time of the audit are a key determinant of jurors' assessments of auditors' personal control and, thus, affect jurors' assessments of auditors' liability (Backof 2015).

Moderating role of assurance clarification

While we expect the presence of clarification and a CAM disclosure in isolation to have opposing and potentially offsetting effects on jurors' perceptions of auditors' personal control, we must also take into consideration the expectation that CAM disclosures in our setting will lead to more intense counterfactual thoughts which, in turn, can lead to harsher evaluations of auditors' negligence. Thus, we again turn to the CCM to better understand how and why clarification can mitigate the unintended consequences of CAM disclosures on jurors' assessments of auditor negligence through its effect on jurors' perceptions of auditors' personal control.

Alicke et al. (2008) explain that counterfactual reasoning will only increase assessments of blame when evaluators perceive the actor had control over the outcome and did not take appropriate precautions to prevent the harmful action. This suggests that clarifying language has the potential to mitigate the negative unintended consequences of a CAM disclosure that invites comparison on auditors' litigation exposure by decreasing the likelihood that such disclosures lead jurors to engage in more intense counterfactual reasoning. Importantly, though, prior research also suggests that the determinants of personal control (i.e., auditors' intentions, causal control, and foresight) may not necessarily be independent of each other. For example, perceived foreseeability often depends heavily on the presence of causal control (Lagnado and Channon 2008). Thus, the extent to which jurors believe that a subsequently identified material misstatement was foreseeable to the auditor at the time of the audit is at least partially a function of the extent to which jurors believe that individual auditors have control over the overall audit process. Consequently, the presence of clarifying language may not only lower jurors' perceptions of auditors' causal control over the adverse outcome, but also prevent a CAM disclosure related to the misstatement

Figure 1 Predicted pattern of cell means

Notes: Figure 1 depicts the predicted pattern of jurors' negligence likelihood means by experimental condition. *Clarifying Language* is manipulated at two levels (No Clarify, Clarify). *CAM Disclosure* is manipulated at two levels (No CAM, CAM). *Negligence Likelihood* is jurors' assessments of the likelihood that the audit firm was negligent where 0 = *not at all likely* and 10 = *extremely likely*.

from increasing jurors' perceptions regarding the foreseeability of the misstatement to the auditor at the time of the audit.⁵

In sum, we expect that clarification of auditors' responsibilities will lower jurors' expectations of the necessary level of assurance that auditors are required to provide. We posit that these lower expectations will, in turn, offer auditors litigation protection by lowering jurors' perceptions of auditors' causal control over the audit failure. Thus, we expect that jurors will perceive auditors as having less personal control over the adverse outcome and, therefore, assess a lower negligence likelihood when the audit report clarifies auditors' responsibilities than when such clarification is missing. As theory does not speak directly to whether the presence of a CAM will increase jurors' assessments of auditor negligence when reasonable assurance is clarified, we do not expect jurors to assess auditor negligence differentially based on the disclosure of a related CAM in the presence of clarifying language.

In contrast, when the audit report does *not* include such clarifying language, we expect that the presence or absence of a CAM disclosure matters. Specifically, when there is *no* disclosure, we posit that jurors will assess a slightly higher negligence likelihood compared to when clarification is present, given the fact that there is no mechanism in place to lower jurors' expectations of auditors or their perceptions of auditors' causal control. Furthermore, we expect that auditors will face the highest negligence likelihood when clarifying language is excluded from the audit report and a CAM disclosure is present. This is because absent clarification, there is nothing to mitigate the negative effect that CAM disclosures have on the intensity of jurors' counterfactual thoughts and the perceived foreseeability of the misstatement to the auditors at the time of the audit.

Taken together, this leads us to predict the pattern of means depicted in Figure 1. Specifically, we predict that jurors are least likely to find auditors negligent when the audit report clarifies what is meant by reasonable assurance regardless of the presence or absence of a CAM

5. As discussed above, foreseeability, causal control, and the actor's intentions are key determinants of the actor's personal control (Alicke 2000). We expect our factors of interest to affect jurors' assessments of the auditors' overall personal control via their beliefs about the foreseeability of the misstatement and the auditors' specific causal influence. However, we do not have sufficient theory to support a directional prediction for jurors' assessments of auditors' intentions. Consistent with prior research (Backof 2015), though, our measure of personal control will capture jurors' assessments of the foreseeability of the misstatement, auditors' causal control, and auditors' intentions.

disclosure. However, when the audit report excludes such clarifying language but does not report a CAM, we predict that jurors will assess a slightly higher negligence likelihood compared to when clarification is present across CAM disclosure conditions. Furthermore, when clarifying language is excluded from the audit report but a CAM disclosure is present, we predict that auditors will face the highest negligence likelihood. Stated formally, we predict the following:

HYPOTHESIS. In settings conducive to counterfactual reasoning, jurors' evaluations of auditor negligence will be highest when the audit report includes a related CAM disclosure but does not clarify the meaning of reasonable assurance and lowest when clarification is present, regardless of the presence or absence of a CAM disclosure. Furthermore, the mitigating effect of clarification on auditors' litigation exposure will be larger in the presence versus absence of a CAM disclosure.

3. Research design

Experimental participants, materials, and procedures

We employ a 2×2 (*Clarifying Language*×*CAM Disclosure*) between-participants factorial design to test our hypothesis. Consistent with prior audit litigation research (Gimbar et al. 2016; Kadous and Mercer 2012; Peecher and Piercey 2008; Reffett 2010), our sample of research participants is comprised of undergraduate students enrolled in an introductory accountancy course at a large southeastern US public university.^{6,7} Our participants met the criteria of eligible jurors, defined as US citizens who are at least 18 years of age (Kadous and Mercer 2012).

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.⁸

The experimental case was adapted from Backof (2015). The primary accounting issue in the case relates to the auditors' evaluation of a lower-of-cost-or-market inventory valuation judgment. We chose this setting because the outcome occurred by a narrow margin (i.e., inventory reported at cost rather than a lower valuation) and there was no use of a specialist, making it conducive to counterfactual thinking. In the case, a creditor alleges that the audit firm was negligent in its audit of the company's inventory account. This alleged negligence resulted in a material overstatement in the financial statements upon which the creditor relied when making its lending decision. The creditor suffered significant losses after the misstatement came to light and the company filed for bankruptcy.

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6. We obtained Institutional Review Board approval prior to participant recruitment for all experiments conducted for purposes of this study.
 7. We did not collect data regarding the declared majors of the student participants. However, of the students enrolled in the courses from which we recruited participants, about 5% were business majors and 15% were accounting majors. The remainder of the students were primarily from applied sciences, general studies, journalism, and liberal arts. Therefore, in addition to being drawn from introductory accounting courses and likely to be accounting and business novices, our participants represented a cross-section of university students.
 8. Jurors in an actual negligence trial would hear oral testimony, as well as see the actual evidence presented during trial. Therefore, to enhance the external validity of our experimental design and participant comprehension of trial materials, we provide an audio recording of the trial lasting approximately 25 minutes in addition to the written transcript containing copies of the documents entered into evidence. All student participants listened to the trial using an individual CD player and headphones.

The trial proceedings included all of the important structural elements, followed the natural order of testimony, and provided appropriate instructions to the jury. After receiving the judge's instructions, participants proceeded to the deliberation phase of the study in which each participant rated the likelihood that the audit firm was negligent and provided a binary verdict decision. Only those participants who found the audit firm negligent were asked to provide monetary damages to be awarded to the plaintiff. Consistent with American Bar Association (ABA 2005) requirements, participants in this phase had access to the plaintiff's complaint and defendant's answer, the judge's instructions, and the exhibits entered into evidence. During the third and final phase of the experiment, participants responded to a series of general questions about the trial and demographic questions.

Independent variables

We manipulated two variables in this study: *Clarifying Language* and *CAM Disclosure* (see Exhibit 1 in the Appendix). Our first independent variable, *Clarifying Language*, was manipulated at two levels. Participants in the No Clarify condition reviewed the current wording used in the standard audit report, while the audit report in the Clarify condition contained the following 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.⁹

In addition, in the Clarify condition, the expert witness for the defense repeats the audit report's clarification in her testimony. Importantly, experimental materials in both *Clarifying Language* conditions include a similar explanation of the auditor's responsibility in the defense attorney's opening statement.¹⁰ Holding this information constant across all conditions biases against us finding that clarifying the meaning of reasonable assurance in the audit report affects jurors' negligence assessments and allows us to examine the incremental effect of including *Clarifying Language* specifically in the audit report rather than at trial in general.

Our second independent variable, *CAM Disclosure*, was manipulated at two levels. In the No CAM condition, the audit report is presented without the inclusion of an emphasis paragraph highlighting the CAM. When it comes to the content of the actual CAM paragraph, auditors must disclose the related audit procedures (IAASB 2015b; PCAOB 2017). Therefore, the audit report in the CAM condition identifies management's lower-of-cost-or-market valuation of ending inventory as a CAM and describes the specific audit procedures performed by the auditors to address the risk of material misstatement.

Dependent variables

The primary purpose of this study is to investigate the effects of the changes in the audit report on jurors' assessments of auditors' negligence. Therefore, our main dependent variable is participants' assessments of the likelihood that the audit firm acted negligently (*Negligence Likelihood*) (0 = *not at all likely*, 10 = *extremely likely*). We also gathered their binary negligence *Verdict*

9. This language was adapted from that provided in AS 1015, *Due Professional Care in the Performance of Work* (PCAOB 2006). We employ the contrasting language found in existing auditing standards (e.g., AS 1015.10, PCAOB 2006) because Lo and Boo (2012) find that providing contrasting statements regarding what a given level of assurance is and is *not* facilitates users' understanding of the term.

10. Specifically, in all conditions, the defense attorney says, "What is most relevant to this case of alleged auditor negligence is whether or not Smith & Company exercised the usual judgment, care, skill, and diligence employed by other CPAs in the community to provide reasonable, not absolute, assurance that the financial statements are free from material misstatement."

Decisions (0 = not negligent, 1 = negligent).¹¹ Consistent with Backof (2015), we measured jurors' perceptions of auditors' *Causal Control* over the adverse outcome (0 = not at all the cause, 10 = completely the cause), the *Foreseeability* of the misstatement to the auditor at the time of the audit (0 = not at all foreseeable, 10 = completely foreseeable), and whether the audit firm intended to conduct a quality risk-based audit (*Intentions*) (0 = not at all intended, 10 = completely intended). We then reduced these measures to a single factor that acts as our measure of jurors' perceptions of auditors' *Personal Control* (eigenvalue = 1.224). Following prior literature (Brasel et al. 2016; Reffett 2010; Sanna and Turley-Ames 2000), we measured the intensity of jurors' counterfactual thoughts by asking jurors to indicate how seriously they thought about what the audit firm could have done differently to prevent the material misstatement (*Counterfactual Intensity*) (0 = not at all seriously, 10 = very seriously), as well as their *Affective Feelings* toward the audit firm (0 = very negative, 10 = very positive). We also captured jurors' perceptions of the level of assurance provided by the audit firm (*Level of Assurance*) (0 = no assurance, 10 = absolute assurance) and the *Perceived Importance* of the audit report (0 = not at all important, 10 = extremely important).

4. Results

Descriptive statistics

A total of 163 undergraduate students voluntarily participated in the study. The average age of participants was 21, and 58% were male. To assess participants' understanding of the issue at hand, we asked them to identify the reason for the misstatement. We exclude 55 participants who failed to identify that valuation of inventory was the sole reason for the misstatement, and report results based on the remaining 108 participants.¹²

To verify that the manipulation of *Clarifying Language* had the intended effect on the underlying construct, the postexperimental questionnaire asked jurors to rate how much assurance that the financial statements are free of material misstatement the auditors are responsible for providing (0 = no assurance, 10 = absolute assurance). As expected, jurors in the Clarify condition believed auditors were responsible for providing less assurance (mean = 5.96) compared to those auditors in the No Clarify condition (mean = 7.36, $t_{106} = -4.63$, one-tailed $p < 0.01$). This suggests a successful manipulation of *Clarifying Language*.

As for the manipulation of *CAM Disclosure*, the postexperimental questionnaire asked jurors to rate how much the audit firm discussed the "valuation of the inventory account" in the audit report (0 = no discussion, 10 = a lot of discussion). Jurors deemed the discussion of the CAM to be greater when the audit report included a CAM disclosure (mean = 5.60) compared to when the audit report lacked any such audit-specific information (mean = 4.69, $F_{1,104} = 5.43$, one-tailed $p = 0.01$). This also suggests a successful manipulation of *CAM Disclosure*.

Finally, we find that both *CAM Disclosure* and *Clarifying Language* have a directional main effect on *Perceived Importance* of the audit report. The report is considered more important when CAMs (mean_{No CAM} = 5.92 vs. mean_{CAM} = 6.72, $F_{1,104} = 4.08$, one-tailed $p = 0.03$) and clarification (mean_{No Clarify} = 5.98 vs. mean_{Clarify} = 6.64, $F_{1,104} = 2.59$, one-tailed $p = 0.06$) are present. Together, this evidence suggests that both clarification and CAM disclosures enhance the perceived importance and arguably the informative value of the audit report.

11. While we report the results of this variable, it is important to note that this binary variable is sensitive to jurors' tolerance for negligence. In contrast, jurors' *Negligence Likelihood* assessments capture jurors' beliefs about auditor negligence regardless of their tolerance for such negligence. Therefore, consistent with Kadous (2000), we focus on our analysis of jurors' *Negligence Likelihood* assessments.

12. Results of untabulated analyses reveal that we obtain similar results when we include the 55 participants who failed to identify the correct reason for the misstatement, indicating that the exclusion of these participants does not affect the conclusions that are drawn in the manuscript.

Tests of hypothesis

We predict an ordinal interaction where negligence likelihood assessments will be highest when clarification is excluded from the audit report but a CAM disclosure is present, and lowest when the audit report clarifies what is meant by reasonable assurance regardless of the presence or absence of a CAM disclosure. Said differently, we expect that clarification will mitigate the increase in auditors' liability exposure associated with a CAM disclosure so that jurors no longer differentially assess auditor negligence based on the disclosure of a related CAM. Furthermore, when the audit report excludes such clarifying language but does not report a CAM, we predict that jurors' assessments of auditor negligence will fall in the middle of these two extremes.

To test our hypothesis, we first estimate an ANOVA model of jurors' *Negligence Likelihood* assessments. Table 1, panel A, reports means for the *Negligence Likelihood* dependent variable, panel B presents the pattern of observed cell means, panel C reports results of the ANOVA model, panel D reports results of the linear contrast test of our interaction prediction, and panel E reports tests of simple effects.

As recommended by Guggenmos et al. (2018), we use visual fit, planned contrasts, semi-omnibus F -test of the residual between-cells variance, and contrast variance residuals (q^2) to test our hypothesis. The pattern of mean *Negligence Likelihood* assessments reported in panel A and visually depicted in panel B of Table 1 generally fits the predicted pattern.¹³ We then formally test our hypothesis using a linear contrast of cell means whereby we assign a contrast weight of +1 to the No Clarify/No CAM condition, +3 to the No Clarify/CAM condition, and -2 to both the Clarify/No CAM and Clarify/CAM conditions. As reported in panel D of Table 1, we find that the observed pattern of *Negligence Likelihood* assessments is consistent with our predicted pattern ($F_{1,104} = 10.54$, two-tailed $p < 0.01$). We also evaluate both the contrast variance residual and conduct a semi-omnibus F -test of the residual between-cells variance in considering potential additional systematic effects in the data not captured in our model. The contrast residual variance metric ($q^2 = 0.08$) indicates that the predicted interaction effect accounts for approximately 92% of the between-cells variance. Finally, the semi-omnibus F -statistic is not significant (semi-omnibus $F_{2,104} = 0.47$, two-tailed $p = 0.63$), suggesting that no statistically significant effects remain after accounting for the contrast. Taken together, the set of analyses presented above provides support for the pattern predicted by our hypothesis.¹⁴

We perform additional analyses to determine if all of the differences predicted by our pattern are significant. As reported in panel C of Table 1, clarification has a main effect on jurors' *Negligence Likelihood* assessments of auditors (mean_{No Clarify} = 5.60 vs. mean_{Clarify} = 4.56, $F_{1,104} = 7.57$, one-tailed $p < 0.01$). However, we also used contrast coding to analyze the simple effects within the ANOVA model as reported in panel E. We find that clarification significantly reduces auditors' liability only in the presence of a CAM disclosure: mean_{No Clarify/CAM} = 6.24 versus mean_{Clarify/CAM} = 4.61, $F_{1,104} = 8.31$, one-tailed $p < 0.01$; mean_{No Clarify/No CAM} = 5.05 versus mean_{Clarify/No CAM} = 4.50, $F_{1,104} = 0.98$, two-tailed $p = 0.32$. Furthermore, we find that

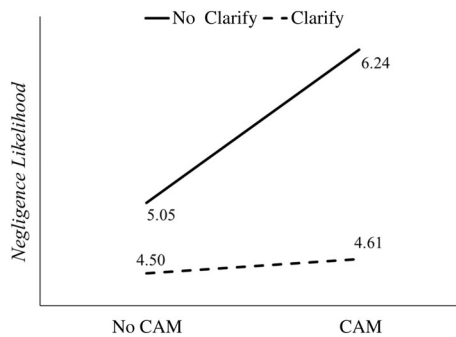
13. The visual fit of jurors' binary verdict decisions to our predicted pattern is not as good as the fit of jurors' negligence likelihood assessments to our predicted pattern (%*Negligent*_{No Clarify/CAM} = 68.0%, %*Negligent*_{No Clarify/No CAM} = 51.7%, %*Negligent*_{Clarify/CAM} = 42.9%, %*Negligent*_{Clarify/No CAM} = 30.8%). However, an untabulated generalized linear model with a logit link offers further support for our hypothesis. Using the same contrast coding described above, we find evidence indicating our predicted ordinal interaction persists in jurors' binary verdicts ($\chi^2_1 = 6.98$, one-tailed $p < 0.01$).
14. We ran three supplemental experiments with MTurk and Qualtrics Panel Management (QPM) participants as robustness tests varying three factors: (i) *Clarifying Language* and *CAM Disclosure* similar to our original experiment but eliminating all discussion of the limitations of reasonable assurance from the oral testimony, (ii) *Clarifying Language* and *CAM Disclosure* similar to our original experiment but using bolded text to draw jurors' attention to the same part of the audit report regardless of the presence or absence of *Clarifying Language*, and (iii) *Clarifying Language* similar to our original experiment but varying the strength of procedures performed to address the CAM; our results hold. See supporting information in the online Appendix for additional details.

TABLE 1
Jurors' assessments of auditor negligence

Panel A: Negligence Likelihood mean (SD) [N]

	No CAM	CAM	
No Clarify	5.05 (2.22) [29]	6.24 (1.74) [25]	5.60 (2.08) [54]
Clarify	4.50 (2.08) [26]	4.61 (2.12) [28]	4.56 (2.08) [54]
	4.79 (2.15) [55]	5.38 (2.10) [53]	

Panel B: Observed pattern of cell means



Panel C: Two-way ANOVA results for Negligence Likelihood

Source of variation	df	MS	F-stat	p-value
Clarifying Language	1	32.10	7.57	<0.01*
CAM Disclosure	1	11.29	2.66	0.11
Clarifying Language × CAM Disclosure	1	7.86	1.86	0.18
Error	104			

Panel D: Planned linear contrast test of interaction

Source of variation	df	MS	F-stat	p-value
Contrast	1	44.68	10.54	<0.01
Residual variance	2	1.99	0.47	0.63
Total variance	3	16.22	3.83	0.01
Error	104	4.24		

Panel E: Simple effects for Negligence Likelihood

Simple effects		F-stat	p-value
CAM Disclosure	No Clarify	4.47	0.02*
	Clarify	0.04	0.85

(The table is continued on the next page.)

TABLE 1 (continued)

Panel E: Simple effects for *Negligence Likelihood*

Simple effects		F-stat	p-value
<i>Clarifying Language</i>	No CAM	0.98	0.32
	CAM	8.31	<0.01*

Notes: Table 1 reports analyses of jurors' assessments of auditor negligence. *Clarifying Language* is manipulated at two levels (No Clarify, Clarify). *CAM Disclosure* is manipulated at two levels (No CAM, CAM). *Negligence Likelihood* is a measure of jurors' assessments of the likelihood that the audit firm was negligent (0 = not at all likely to 10 = extremely likely). *One-tailed p-value for test of directional prediction. All other p-values are two-tailed.

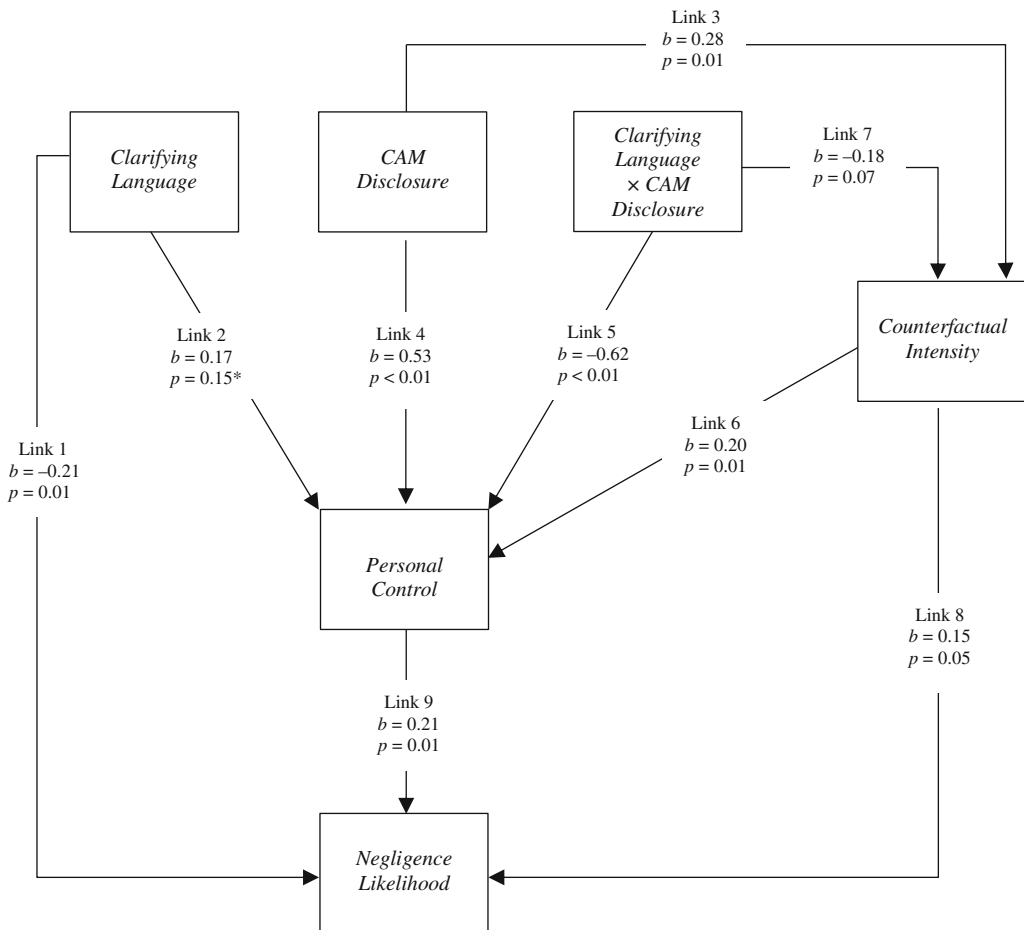
CAM disclosures have no impact on auditors' liability in the presence of clarification: mean_{Clarify/CAM} = 4.61 versus mean_{Clarify/No CAM} = 4.50, $F_{1,104} = 0.04$, two-tailed $p = 0.85$. Finally, we see that in the absence of clarification, the inclusion of a CAM disclosure in the auditor report increases jurors' assessments of auditor liability compared to when such a disclosure is excluded from the audit report: mean_{No Clarify/CAM} = 6.24 versus mean_{No Clarify/No CAM} = 5.05, $F_{1,104} = 4.47$, one-tailed $p = 0.02$.

Analyses of other process measures

Our process measures provide further insight into some of the differences reported above. Recall that, consistent with our theory, we find evidence that our manipulation successfully lowered jurors' expectations regarding the *Level of Assurance* auditors are required to provide (mean_{Clarify} = 5.96 vs. mean_{No Clarify} = 7.36). Untabulated analyses also reveal that, as predicted, the presence of *Clarifying Language* lowers jurors' perceptions of auditors' *Causal Control* over the misstatement: mean_{Clarify} = 4.01 versus mean_{No Clarify} = 5.88, $F_{1,104} = 18.05$, one-tailed $p < 0.01$. As *Causal Control* is a key determinant of *Personal Control*, clarification leads jurors to assess auditors as having less *Personal Control* over the adverse outcome: mean_{Clarify} = -0.17 versus mean_{No Clarify} = 0.17, $F_{1,104} = 4.79$, one-tailed $p = 0.02$. Together, the effect of clarification on jurors' expectations and evaluations of auditors explain why we find evidence of this main effect.

Our measures also shed light on why CAMs matter in the absence of clarification. Untabulated analyses of the intensity of jurors' counterfactual thoughts about what else could have been done to avoid the adverse outcome reveal that jurors in the No Clarify/CAM condition report experiencing higher *Counterfactual Intensity* while considering the case (mean = 7.86) than those jurors in the No Clarify/No CAM condition (mean = 6.55, $F_{1,104} = 6.27$, one-tailed $p = 0.01$).¹⁵ Furthermore, as expected, in the absence of *Clarifying Language*, the inclusion of a related *CAM Disclosure* leads jurors to view the misstatement as more *foreseeable* to the auditor at the time of the audit: mean_{No Clarify/CAM} = 7.50 versus mean_{No Clarify/No CAM} = 4.55, $F_{1,104} = 27.67$, one-tailed $p < 0.01$. This, in turn, helps to explain why we find that jurors perceive auditors as having more *Personal Control* over the adverse outcome: mean_{No Clarify/CAM} = 0.80 versus mean_{No Clarify/No CAM} = -0.38, $F_{1,104} = 23.29$, one-tailed $p < 0.01$. Importantly, we also find that none of these differences are statistically significant in the presence of clarification (all two-tailed $p \geq 0.16$).

15. Prior research (see Roese 1994) has shown that counterfactual thinking is often activated in response to negative affect. Thus, we expect that jurors experiencing more intense counterfactuals should also report more negative affective responses to the audit firm. Consistent with this expectation, jurors in the No Clarify/CAM condition have marginally more negative *Affective Feelings* toward the audit firm (mean = 3.70) compared to those of jurors in the No Clarify/No CAM condition (mean = 4.45, $F_{1,104} = 1.32$, one-tailed $p = 0.09$).

Figure 2 Hypothesized model of jurors' assessments of auditor negligence

Notes: This figure shows the results of the structural equation model that simultaneously tests the relationships among the proposed mediating variables. Standardized path coefficients and corresponding p -values are shown next to each path. *Clarifying Language* is dummy coded for purposes of this analysis (0 = No Clarify, 1 = Clarify), as is *CAM Disclosure* (0 = No CAM, 1 = CAM). *Personal Control* refers to the factor score based on participants' assessments of auditors' *Causal Control* over the adverse outcome, *Foreseeability* of the misstatement to the auditor at the time of the audit, and auditors' *Intentions* to conduct a quality audit. *Counterfactual Intensity* refers to the intensity of participants' thoughts of (i.e., how "hard" they thought about) what the auditors could have done differently to detect the misstatement where 0 = *not at all hard* and 10 = *very hard*. *Negligence Likelihood* is a measure of jurors' assessments of the likelihood that the audit firm was negligent where 0 = *not at all likely* and 10 = *extremely likely*. It should be noted that we do not include the direct effect of a *CAM Disclosure* or the interaction in our model as we did not hypothesize a direct effect of those variables on *Negligence Likelihood* assessments. Consistent with this logic, an untabulated structural equation model in which we include those two direct effects confirms that neither of those direct effects are significant (all two-tailed $p \geq 0.37$) and our results presented above hold. *All p -values are one-tailed for hypothesized directional effects with the exception of Link 2. The path coefficient for Link 2 is in the direction opposite of our prediction. Hence, we report a two-tailed p -value for this link only.

Test of overall model

In order to provide more insight into the cognitive process underlying our results, we next conduct a test of our overall theoretical model. Figure 2 depicts the model and reports test results of

the model's structure. A likelihood ratio chi-square test indicates that the model-implied covariance matrix does not differ from the observed covariance matrix ($\chi^2 = 1.78$, two-tailed $p = 0.62$), indicating a good fit. The Tucker–Lewis Index is 1.04 and the incremental fit index is 1.01, both of which exceed the 0.95 standard cutoff value for an acceptable fit (Hu and Bentler 1999). Therefore, the overall model describes the relationships in the data well.

In the absence of a CAM disclosure, we find that clarification of what is meant by reasonable assurance directly reduces jurors' *Negligence Likelihood* assessments (Link 1, one-tailed $p = 0.01$) but not their perceptions of *Personal Control* (Link 2, two-tailed $p = 0.15$).¹⁶ Rather, the impact of clarification on jurors' perceptions of *Personal Control* depends on the presence or absence of a *CAM Disclosure*. More specifically, and consistent with our expectations, a CAM disclosure absent clarification increases both jurors' *Counterfactual Intensity* (Link 3, one-tailed $p = 0.01$) and jurors' perceptions of auditors' *Personal Control* over the adverse outcome (Link 4, one-tailed $p < 0.01$). As predicted, though, the inclusion of clarifying language in an audit report containing a CAM disclosure lowers jurors' perceptions of *Personal Control* both directly (Link 5, one-tailed $p < 0.01$) and indirectly (Link 6, one-tailed $p = 0.01$) through its effect on the *Counterfactual Intensity* of jurors' thoughts (Link 7, one-tailed $p = 0.07$). Finally, consistent with prior research (Backof 2015; Reffett 2010), both the *Counterfactual Intensity* of jurors' thoughts (Link 8, one-tailed $p = 0.05$) and their perceptions of auditors' *Personal Control* over the adverse outcome (Link 9, one-tailed $p = 0.01$) directly affect jurors' *Negligence Likelihood* assessments.

5. Conclusion

In conclusion, this study explores how clarification of auditors' responsibility affects jurors' perceptions of auditors and why this clarification matters under the new audit reporting model. Our study resulted in three important findings. First, we find that clarifying the meaning of reasonable assurance serves to reduce auditors' litigation risk. Specifically, when the audit report clarifies that reasonable assurance is a high level of assurance but does not provide absolute assurance that every material misstatement will be detected, jurors judge auditors to be less negligent than when the audit report does not include clarification. Consistent with our theory, we find that clarification provides this litigation protection by lowering jurors' expectations regarding the amount of assurance auditors are required to provide, which, in turn, reduces jurors' beliefs about the audit firm's causal control over the undetected misstatement.

Second, in a setting conducive to counterfactual reasoning, we find that when the meaning of reasonable assurance is not clarified in the audit report, jurors assess auditors as more negligent when the audit report includes a CAM disclosure related to the undetected misstatement compared to when no such disclosure is made in the audit report. Consistent with our theory, we find that this occurs because jurors evaluate the undetected misstatement as more foreseeable to the auditor at the time of the audit.

Finally, we find clarifying language moderates the effect of CAMs on jurors' assessments of auditor negligence. Specifically, jurors judge auditors most negligent when the audit report

16. We report a two-tailed p -value for Link 2 because the coefficient is inconsistent with our directional expectation. An untabulated ANOVA model examining the impact of *Clarifying Language* and a *CAM Disclosure* on jurors' perceptions of auditors' *Personal Control* reveals that the presence of clarification significantly decreases ($\text{mean}_{\text{No Clarify}} = 0.17$ vs. $\text{mean}_{\text{Clarify}} = -0.17$, $F_{1,104} = 4.79$, two-tailed $p = 0.03$), and the disclosure of a CAM significantly increases ($\text{mean}_{\text{No CAM}} = -0.19$ vs. $\text{mean}_{\text{CAM}} = 0.20$, $F_{1,104} = 5.87$, two-tailed $p = 0.02$) perceived *Personal Control*. However, the significant interaction ($F_{1,104} = 19.45$, two-tailed $p < 0.01$) indicates that the effect of clarification depends on the presence or absence of a CAM disclosure. Specifically, clarification *reduces* perceived *Personal Control* in the presence of a *CAM Disclosure* ($F_{1,104} = 21.37$, one-tailed $p < 0.01$) but not when such a disclosure is missing ($F_{1,104} = 2.52$, two-tailed $p = 0.12$). Furthermore, a *CAM Disclosure* increases perceived *Personal Control* when *Clarifying Language* is excluded from the audit report ($F_{1,104} = 23.29$, one-tailed $p < 0.01$) but not when such language is included in the report ($F_{1,104} = 1.98$, two-tailed $p = 0.16$).

contains a CAM but does not clarify the meaning of reasonable assurance. However, the addition of such clarifying language effectively mitigates the negative effect that CAM disclosures have on the intensity of jurors' counterfactual thoughts, the perceived foreseeability of the misstatement to the auditors at the time of the audit, and jurors' perceptions of auditors' personal control over the adverse outcome.

Our findings contribute to both practice and theory in important ways. First, our findings contribute to the auditor negligence literature by demonstrating how clarifying the meaning of reasonable assurance reduces auditors' litigation exposure by significantly lowering jurors' expectations of auditors' responsibilities and their perceptions of auditors' causal control over the adverse outcome. Second, we complement the prior literature (Gimbar et al. 2016; Kachelmeier et al. 2020) by verifying that CAMs have the potential to increase jurors' assessments of auditor negligence in settings conducive to counterfactual reasoning. Furthermore, we demonstrate that clarifying the meaning of reasonable assurance effectively mitigates the increase in auditors' liability exposure in such settings so that jurors no longer differentially assess auditor negligence based on the disclosure of a related CAM.

Collectively, these insights will assist audit standard setters in their evaluation of the potential ramifications of newly issued and proposed standards related to the audit reporting model. Specifically, while all major audit standard setters have adopted standards that either require (IAASB 2015b; PCAOB 2017) or allow (AICPA 2019) CAM disclosures, they differ on whether to require clarification of reasonable assurance in the audit report. In particular, the IAASB's (ISA 700 ¶37b, IAASB 2015a) and the ASB's (AICPA 2019) new standards require that the audit report include language clarifying the meaning of reasonable assurance. The PCAOB's standard does not (PCAOB 2017). Our study contributes to this ongoing debate regarding the importance of clarification of auditors' responsibilities by providing evidence regarding the role clarification plays in auditors' litigation. However, there are still more questions to be answered regarding the potential protection provided by assurance clarification. For example, does assurance clarification mitigate auditors' heightened litigation exposure under imprecise accounting standards? Do jurors view auditors who perform work around an undetected fraud or material error less harshly when the limitations of reasonable assurance are clarified? Furthermore, for auditors who have clients that are cross-listed on multiple exchanges, is there an advantage to producing two reports on the same set of financial statements given that the clarifying language required by the IAASB will likely mitigate the heightened litigation risk associated with the CAM disclosure? We encourage future research in this area in light of standard setters' differing views on the importance of clarification in the audit report.

In addition, there are numerous differences between the PCAOB's audit reporting model and the reporting model adopted by the IAASB that are not examined in this study that could potentially impact jurors' decision-making. For example, the PCAOB report discusses auditor tenure yet such information is not included in the audit reports compiled in accordance with IAASB standards. Another notable difference is the disclosure of the lead engagement audit partner's name. This information is included in the international audit reporting model while the PCAOB requires a separate disclosure of the partner's identity in Form AP. We encourage future research to explore how these differences in audit reporting models affect auditors' litigation exposure individually as well as in the aggregate.

Appendix

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. **[Clarify condition only: 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.

[CAM condition only:

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. 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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SUPPORTING INFORMATION

Additional supporting information may be found in the online version of this article:

Online Appendix. Supporting information