

The Impact of Auditor Reputation on Jurors' Assessment of Auditor Liability in a Limited Liability Regime: Financially Important Nonpublic Clients

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AICPA Ethics Interpretation 501-8 permits the use of limitation of liability clauses in jurisdictions where they are allowed (AICPA 2013). This study advances Brandon and Mueller's (2006) research to examine the impact of auditor reputation on jurors' perceptions of auditor liability when the client is financially important. The results indicate an auditor's reputation neither significantly impact jurors' evaluation of auditor liability, nor does it significantly reduce the incidence of punitive damages assigned to the auditor. Surprisingly, auditors with a reputation for high quality are punished more harshly following an audit failure in the presence of a limitation of liability clause.

INTRODUCTION

Accounting literature focuses on two principal forces that impact audit quality: litigation incentives and reputation incentives (Skinner and Srinivasan, 2012). Litigation incentives motivate auditors to provide high quality audits in order to avoid litigation costs (DeFond et al. 2002, p. 1251), while reputation incentives protect auditors against current losses (Krishnamuthy et al. 2006) and future losses (Mayhew et al., 2001). Datar and Alles (1999, p. 402) indicate that in the absence of litigation, auditors have a strong incentive to maintain their reputation for quality. While the Securities and Exchange Commission prohibits auditors from using limitation of liability clauses due to concerns about auditor independence, the AICPA's Professional Ethics Executive Committee's Ethics Interpretation

501-8 allows the use of limitation of liability clauses for auditors of nonpublic clients. Prior literature has not examined the impact of an auditor's reputation on perceptions of auditor liability in the presence of a limited liability agreement. This research experimentally examines this subject for a number of reasons.

First, the Committee on Capital Markets Regulation (2006) posits that auditor reputation concerns should be investigated whenever limitations on liability are discussed. Bigus (2011) suggests that the potential for reputation losses and gains motivate auditors to exercise higher levels of care in the attest engagement. It is important to understand jurors' perceptions of reputation as an incentive to induce audit quality in the presence of a limitation of liability clause, since jurors are often instrumental to the outcome of auditor litigation cases. Second, Wilson and Grimlund (1990) find that a decline in an audit firm's reputation resulting from disciplinary actions from the Securities and Exchange Committee leads to real economic consequences. A thorough review of the literature finds that no study has experimentally examined whether an auditor suffers real economic consequences (punitive damages) resulting from negligence following an audit for a nonpublic client in a limited liability regime. This study addresses that issue. Finally, research that investigates the impact of auditor reputation in a limited liability regime is

scarce, possibly due to literature that focuses on other factors that are important to auditor liability (Bigus 2011, p. 289). Watkins et al. (2004, p. 165) suggest that research examining the relationship between audit quality and the legal environment is an area of fruitful research. Skinner and Srinivasan (2012, p. 1738) address the difficulty in separating the effects of reputation from those of litigation. Experimental research allows the researcher to control the level of each factor presented in the experiment. In general, a void in the literature exists regarding the effects of factors specific to the accounting profession on jurors' decisions (Bonner, 1999). Brandon and Mueller (2006, p. 14) suggest that future research examines other factors that may impact jurors' evaluations of auditors in an effort to better understand auditor litigation outcomes. Literature is also scant with respect to jurors' assignment of auditor liability to an auditor when an audit failure occurs subsequent to an engagement in which the auditor and a nonpublic client employ a limited liability agreement. For these reasons, the present research experimentally examines the impact of an auditor's reputation on jurors' evaluations of negligence and damage award judgments subsequent to the audit failure in which the auditor and a financially nonpublic client enter into a limited liability agreement.

This study adapts a case from Brandon and Mueller (2006) and Kadous (2000), with permission. Mock jurors learn that an auditor executed a limited liability agreement with a financially important nonpublic client prior a failed audit. The auditor's reputation for audit quality is manipulated as an auditor having either (1) a high reputation for quality or (2) a low reputation for quality. The quality offered by the high reputation firm involves the auditor executing an audit procedure that is recommended by Generally Accepted Auditing Standards, but not required. The low reputation firm does not perform the procedure. "Effort exerted in the audit" is operationalized as a proxy for audit quality, which is motivated by Kadous (2000). A post-experiment questionnaire elicits jurors' assessments of auditor liability and damage awards.

The results indicate that participants perceive auditors with a high reputation for quality as being more objective and more independent than firms with a low reputation for quality. However, neither the limitation of liability clause nor the auditor's reputation impacts participants' perceptions of audit quality or concerns regarding the auditor's desire to retain a financially important client. Auditor reputation is found to be nonsignificant in the assignment of liability to the auditor subsequent to an audit failure in the presence of a limited liability agreement with a financially important client (hypothesis one). However, auditor reputation significantly impacts the amount of damage awards assigned to the auditor

(hypothesis two). Finally, auditor reputation is not statistically significant to the assignment of compensatory awards to the plaintiff.

The results contribute to this research stream by providing experimental evidence that auditor reputation may not be perceived by jurors as a sufficient safeguard to ensure auditor independence. Prior research suggests that inherent safeguards such as reputational loss encourage auditor independence in the presence of economic bonding (Hollingsworth and Li, 2012; DeFond et al., 2002). The current results suggest otherwise from a juror perspective. An understanding of jurors' perceptions of auditor liability are critical to the accounting profession, as jurors' perceptions—not reality—may ultimately determine an auditor's fate in court (Brandon and Mueller 2006, p. 3).

The remainder of the paper is organized as follows: Section II reviews the literature and presents the hypotheses. Section III presents the methodology, followed by a discussion of the findings in

Section IV. Section V concludes the research.

LITERATURE REVIEW

AICPA Ethics Interpretation 501-8

Limitation of liability clauses have received increasing attention in recent years as a means of protecting auditors against extraordinary litigation costs arising from an audit failure. While international countries such as the United Kingdom and the European Union use limitation of liability clauses (Reinstein et al. 2009, p. 55), the Securities and Exchange Commission precludes auditors of public companies from entering into such agreements with public clients. The AICPA's Professional Ethics

Executive Committee issued Ethics Interpretation 501-8, which does not explicitly prohibit auditors from engaging in limited liability agreements with nonpublic companies. The Ethics Interpretation infers that auditors who fail to comply with the regulatory guidance of the jurisdiction in which they operate are deemed to have committed a “discreditable act” to the profession (AICPA, 2013).

Practitioner literature embraces limitation of liability clauses for their ability to shield auditors from excessive financial losses that may be brought against the auditor by a client

(Reinstein et al. 2009, 52). Conversely, academic literature suggests that the threat of litigation serves as a mechanism to regulate behavior (Latham and Linville 1998, 177). Accounting regulators also agree that the reduction of an auditor’s exposure to liability impairs the auditor’s independence, thereby encouraging the auditor to compromise their objectivity and to conduct lower quality audits.

Similar concerns were raised when proportional liability rule was introduced through the Private Securities Litigation Reform Act of 1995 (Geiger et al., 2006). Chan and Pae (1998) find that proportionate liability decreases both audit effort and lawsuit probability. However, Narayanan (1994) proposes that a proportionate liability regime incentivizes an auditor to increase the amount of effort exerted during the engagement, despite the fact that a joint and severally liability regime may lead to a higher level of liability. Giger (1994) concurs, suggesting that an incremental increase in liability determines the effort exerted by an auditor in an engagement.

Auditor Reputation for Audit Quality

Reputation is a complex, multidimensional construct which is difficult to examine (McCracken 2003, p. 165). Lennox’s (1999, p. 780) reputation hypothesis states that in the absence of litigation, larger audit firms (i.e. higher quality firms) have an incentive to protect their reputation for quality. Recent research finds that auditor reputation and audit quality are important when the threat of litigation is not strong enough to motivate the auditor to deliver quality (Skinner and Srinivasan 2012, p. 1739). Extant research also finds that an auditor’s reputation costs differ from an auditor’s legal costs, in that legal penalties impact existing wealth, whereas reputation damages impact the loss of both current audit clients (Chaney and Philipich, 2002; Krishnamurthy et al., 2006; Wilson and Grimlund, 1990) as well as future wealth (Mayhew et al., 2001, p. 51). This suggests that both an auditor’s reputation for high quality as well as the auditor’s future ability to earn income is at stake when the auditor fails to provide a correct audit opinion.

Several dimensions of auditor reputation have been examined in prior literature, including an auditor’s reputation as a “settler” or a “fighter” (Che and Yi, 1993), reputation strategy when facing litigation (McCracken, 2003; Cushing and Gilbertson, 2002); reputation formation and client continuity (Datar and Alles, 1999), auditor reputation and initial public offerings (Michaely and Shaw, 1995), consequences of decline in auditor reputation (Wilson and Grimlund, 1990), and whether auditor reputation ensures audit quality (Weber et al., 2008). Dees (1992, p. 26) suggests that reputation may function as a socially mediated control for regulating self-interested behavior. The current research examines auditor reputation in this capacity.

Audit quality relates to the accuracy of information reported on by an auditor (Titman and Trueman 1986; Krinsky and Rutenberg 1989; Davidson and Neu 1993), as well as various levels of assurance regarding the likelihood that financial statements are free of errors or misstatements

(Palmrose 1988, p. 56). DeAngelo (1981) suggests that an auditor’s reputation may serve as one dimension of audit quality, since the quality of the external audit is unobservable to the public. Audit firms take great care to ensure that their reputation for quality is maintained in order to retain their clients and to preserve their market share (Wilson and Grimlund 1990, p. 43). Watkins et al. (2004, p. 153) dichotomize audit quality into two components: actual monitoring strength and perceived auditor reputation. An auditor’s reputation affects financial statement users’ perceptions of (1) financial statement credibility and (2) auditor objectivity during the engagement (Watkins et al. 2004, p. 156). The proceeding section proposes a theoretical view of how an auditor’s reputation for quality may be perceived as an incentive to remain independent and to be objective during an attest engagement.

Incentives and the Social Cognitive Theory

Peterson and Luthans (2006, p. 162) find that in the long run, both financial and nonfinancial incentives significantly impact business-unit outcomes, as the initial discrepancy between financial and nonfinancial incentives dissipate over time. Limitation of liability clauses dampen the threat of litigation (financial incentive), which encourages auditors to conduct high quality audits. However, it is possible that auditors' concerns about their own reputation (nonfinancial incentive) may dissuade auditors from compromising their objectivity and quality during the engagement, thus preserving their own reputation and ensuring that future revenues are not compromised.

Bandura's (1986) social cognitive theory provides the theoretical underpinning for advancing the premise by which this research presupposes that jurors may perceive an auditor's reputation as a nonfinancial incentive for remaining independent in a limited liability regime. The social cognitive theory is an appropriate theory to analyze the nature of social recognition (Stajkovic and Luthans 2001, p. 582). It is not the intent of this study to examine jurors' behavior using the social cognitive theory. However, the theory may explain jurors' reasoning as to why they may perceive auditor reputation as a sufficient nonfinancial incentive to induce the auditor to remain independent when auditor liability (financial incentive) is reduced by a limited liability agreement.

Social recognition derives its outcome utility from its predictive value (Bandura, 1986). An auditor's reputation for quality is a form of social recognition, which derives its outcome utility from potential future audit clients. People (auditors) engage in behaviors (auditor objectivity) that receive social recognition (auditor reputation for quality) and avoid behaviors that lead to the disapproval of others.

The informative content associated with an auditor's reputation resides in the content of promising outcomes that have been delivered (Stajkovic and Luthans 2001, p. 583). The content desired by users of audited financial statements is that an independent, objective auditor has issued the correct opinion on the client's financial statements after conducting a high-quality audit in conformity with generally accepted auditing standards.

Finally, Bandura's (1986) social cognitive theory suggests that the regulatory mechanism engages auditors to self-regulate their future behaviors (auditor objectivity) by planning for objectivity and by anticipating the consequences of not being objective during the engagement. This suggests that an auditor's required planning of the audit and anticipation of desirable events is a self-regulatory mechanism by which the future outcomes identified through social recognition (auditor reputation for high quality) is transferred into action (Stajkovic and Luthans 2001, p. 583).

Hypotheses Development

An auditor's greatest assets are arguably independence and objectivity. These auditor characteristics increase the likelihood that an auditor issues the correct audit opinion on the financial statements. According to Watkins et al. (2004), audit quality "embrace[s]...the dimensions of competence and independence in actuality as well as how they are perceived." A high-quality audit environment begins with institutions that regulate and incentivize their auditors to remain competent, independent, and objective in the decisions they make during the audit engagement (Francis, 2011).

The threat of an auditor's damaged reputation may serve as an effective incentive to keep auditors independent in fact (Reynolds and Francis, 2001; DeFond et al., 2002). Brandon and Mueller (2006, p. 3) propose that a jurors' perceptions—not reality—are instrumental to determining an auditor's fate in court. Thus, an auditor's reputation for quality may not only influence the auditor to remain objective in an audit, but may also impact jurors' perceptions of auditor liability in the event of litigation.

Extant research provides mixed results concerning auditor reputation as an incentive to provide a quality audit. An auditor's reputation for audit quality is most recognized when an auditor issues the proper audit report. Raghunandan and Rama (1995, p. 52) indicate that auditors suffer reputation loss when an auditor fails to correctly issue a going-concern report to a client that later experiences bankruptcy. Datar and Alles (1992, p. 415) suggest that an auditor's concern about his or her reputation incentivizes the auditor to provide a high-quality audit, which directly reduces frivolous lawsuits. Conversely, Lennox (1999, p. 780) does not find a diminished demand for auditors with damaged

reputations (e.g. criticized auditors), thereby negating audit reputation as an incentive to conduct a high quality audit. Thus, an empirical question exists as to whether jurors perceive auditor reputation as a sufficient nonfinancial incentive to motivate an auditor to conduct a high quality audit when financial incentives (punitive litigation damages) are minimized by a limited liability agreement.

Predicting the impact of auditor reputation on jurors' assessments of auditor liability in a limited liability regime is complex, because no directly germane prior research exists. Two lines of reasoning may be advanced regarding the impact of auditor reputation on jurors' evaluations of auditor liability. Jennings et al. (2006) contend that the most sinister scenario is one of a conspiracy between a nonindependent auditor and a client lacking a culture of integrity. Brandon and Mueller (2006) conclude that to the extent that jurors perceive an auditor's independence to be impaired, blame and punishment is intensified. Presuming that jurors believe a limited liability agreement impairs an auditor's independence, an attribution of maximum auditor liability can be most easily reached when the auditor has a low reputation for quality and the client is financially important to the auditor. This line of reasoning suggests that—in a scenario where an audit failure occurs and a limited liability agreement has been executed—auditor liability would be greatest if an auditor with a low reputation is perceived to be nonindependent.

An alternative line of reasoning posits that auditors with a reputation for high quality may be assessed lower evaluations of liability in the presence of a limited liability agreement, due to the fact that high audit quality often involves auditors who exert more effort in the audit engagement (Kadous, 2000). Further, jurors would be more likely to perceive the auditor as being objective under this condition, thereby confirming the theory that auditor reputation concerns are a sufficient nonfinancial incentive for the auditor to remain objective in the absence of the threat of litigation. Accordingly, this issue is investigated in the following hypothesis:

H1: Juror evaluations of auditor liability will be lower subsequent to an audit failure involving an auditor with a high reputation for quality who employs a limitation of liability clause with a financially important nonpublic client.

Brandon and Mueller (2006, 4) find that jurors are more likely to exact punitive damages to the auditor when the client is financially important to the firm, since punitive damage serve to punish and deter adverse behavior in the future (Anderson and McCoun, 1999; Shroyer, 1991). Brandon and Mueller (2006, 4) also posit that people infer intent and intensify punishment when motives are perceived. The current research investigates whether an auditor's reputation for quality significantly influences jurors' perceptions of the auditor's motive to mislead others in a limited liability context. The second hypothesis examines whether an auditor's reputation affects jurors' assignment of punitive damages (H2a) to the auditor under these conditions, as well as in the assignment of the punitive damage pecuniary awards (H2b), as follows:

H2a: Jurors will be less likely to punish the auditor, via punitive damages, when an auditor with a reputation for high quality engages in an LLA with a financially important nonpublic client.

H2b: Punitive awards will be lower when an auditor with a reputation for high quality engages in an LLA with a financially important nonpublic client.

METHODOLOGY

Materials and Research Task

The experiment is adapted from Brandon and Mueller (2006) and Kadous (2000), with permission. The experiment involves a lawsuit where a CPA firm is being sued by a bank that made a loan to a client whose financial statements were audited by the CPA firm. The CPA firm allegedly over-valued the client's inventory, and the bank relied on the financial statements to provide a loan to the client. In

addition to the auditor's reputation, the auditor liability context of this case is instrumental to perceptions of the dependent variables. Prior to the audit, the auditor and the client agreed that the auditor's liability would not exceed (1) the total value of the client or (2) the portion of the damages for which the CPA firm is responsible.

The experimental task is to assess the firm's overall ability to conduct the financial statement audit, as well as the extent of the liability (if any) that should be assigned to the CPA firm at the conclusion of the lawsuit. The primary dependent variables are participants' assessments of engagement quality and auditor liability. Assessments of continuous variables are measured using a 10-point Likert scale, anchored at 1 = Completely Disagree, and 10 = Completely Agree. On average, participants completed the experiment in approximately twenty-six minutes, which was in concert with the desire to limit the time of completion to less than thirty minutes.

Design

Auditor Reputation Manipulation

A between-subjects experimental design was employed to understand the impact of auditor reputation on auditor liability and punitive damages in a limited liability context. Auditor reputation for quality is manipulated as either a high reputation for quality or a low reputation for audit quality. The reputation manipulation is motivated by Grunwald and Hempelman (2010), who manipulate the high-reputation firm as one that is known for its good conduct, high standards of production, and no major reporting of incidences. The low reputation firm is known for below average production, and has been subject to public investigations in the past. This independent measure of auditor reputation is more suitable for the present research study than other auditor reputation measures (McCracken, S. A., 2003; Koch and Schmidt, 2010; Wilson and Grimlund, 1990).

Audit Quality Manipulation

An inability to directly observe audit quality establishes the need to choose an appropriate, reasonable proxy to represent the level of quality conducive to each firm's reputation. Several proxies have been used for audit quality, including accounting firm size (DeAngelo 1981), self-regulated peer review processes (Casterella et al., 2009, Hilary and Lennox, 2005), and PCAOB inspections (Lennox and Pittman, 2010). Palmrose (1988, 56) establishes the use of litigation in making decisions about audit quality. Other studies suggest that the damage apportionment rules proposed by different legal regimes influence audit quality (Narayanan, 1994; Schwartz, 1997; Hillegeist, 1999; Lee and Mande, 2003).

According to Narayanan (1994, 41), audit quality is determined by audit effort. Narayanan (1994, 52) concludes that under a proportional liability system, an auditor is likely to exert more effort to ensure the financial statements are correct in an effort to possibly absolve himself or herself of all liability. While Chan and Pae (1998, 473-474) confirm investors' concerns that a reduction in auditor liability is related to a reduction in audit effort, they also suggest that a reduction in liability—such as a move from a joint and severally liable regime to a proportionate liability regime—reduces the tendency to “over-audit” during an engagement, thereby, lowering the client's cost of the audit. Pae and Yoo's (2001, 335) results show similar benefits regarding this social welfare that reduces the tendency to “over-audit” a client. For these reasons, the current research selects audit effort as a proxy for audit quality.

“High” and “low” levels of audit quality are operationalized using auditor effort as a proxy for audit quality. The auditor effort proxy is motivated by Kadous (2000, p. 332). In the experimental materials, jurors are presented with a scenario whereby Generally Accepted Auditing Standards provide auditors with an option (but not a requirement) to consult with a specialist to provide a stronger test of inventory quantities than estimation. Auditor effort is manipulated in the higher audit quality condition as the auditor consulting an engineering firm to obtain a more accurate measurement of inventory. In the lower audit quality condition, the auditor does not consult a specialist. The auditor is described in each manipulation as follows:

Smith & Watkins has a reputation for conducting high quality audits. The audit firm has never been subject to investigations violating any of the Generally Accepted Auditing Standards in the past.

Smith & Watkins has a reputation for conducting low quality audits. The audit firm has been subject to investigations for violating Generally Accepted Auditing Standards in the past.

Participants

The examination of individual juror evaluations is important because they allow for more efficient tests than group jury evaluations (Kadous, 2000, p. 330). Kassin and Wrightsman (1988) suggest that focusing on individual juror decisions may be appropriate due to the variation in jury size and decision rules in different jurisdictions.

Extant research supports the use of college undergraduates as appropriate proxies for jurors (Brandon and Mueller, 2006; Kadous, 2000). Data was collected from students in introductory business and accounting classes at a comprehensive university in the Southeastern United States during normal class hours. Minimal extra credit was offered as a reward for students who participated in the research.

On average, participants were 26 years old, with ages ranging from 19 to 57 years. Approximately 37 percent of the participants were male. Nearly 34 percent of the participants indicated that they had taken two accounting courses. Over 57 percent of the participants had taken one law or political science course at the time of the study. Almost 20 percent of the participants indicated that they previously owned stock, while 17 percent indicated that they currently owned stock.

A total of 122 responses were collected. Of these, eighty-two usable responses were retained. Sixteen responses (13.1 percent) were removed due to incomplete information provided by the participants. Another twenty-four (19.7 percent) participants failed to correctly respond to the manipulation check question.

Dependent Variables

The primary dependent variables measure participants' assessments of auditor liability for negligence, compensatory damage awards, and punitive awards. Consistent with Brandon and Mueller (2006), participants provide a liability rating by responding to a dichotomous response as to whether the auditor is guilty of negligence, followed by a seven-point confidence-in-verdict question. The dichotomous liability judgment and the confidence-in-verdict-assessments were combined to produce a 14-point liability rating scale, anchored at 1 = not guilty and 14 = guilty. Extant research provides evidence that this combined measure is more predictive than a single dichotomous response (MacCoun, 1996, Stasser and Davis, 1981).

RESULTS

Manipulation Check for Auditor Reputation

The post-test questionnaire asked participants to respond to the following question regarding the auditor's reputation for quality: What is Smith & Watkins CPA Firm's reputation for audit quality? Participants responded on a ten-point Likert-scale, with the following anchors: 1 = Reputation for LOW Audit Quality and 10 = Reputation for HIGH Audit Quality. The mean reputation assessment in the high reputation condition is significantly higher than in the low reputation (mean = 8.90 and mean = 4.40, respectively; $t = 5.960$, $p = 0.000$).

Participants were asked to determine whether the auditor is guilty of negligence during the audit, and if so, should punitive damages be assessed to the auditor. Of the eighty-two usable responses, 36 participants (85.7 percent) in the low reputation condition indicated the firm was negligent during the audit, while 32 (82.0 percent) participants in the high reputation condition indicated that the firm was negligent; these difference are not statistically different (Chi-square = 0.098, $p = 0.755$). Participants who

indicated that the auditor is guilty of negligence assigned guilt in the expected direction, but the results are not statistically different (high reputation = 50.0 percent, low reputation = 66.7 percent; Chi-square = 2.345, $p = 0.126$).

Preliminary Analyses

The preliminary analysis examines the impact of auditor reputation on jurors' perceptions of the auditor's independence, motives, responsibility, and blameworthiness following the audit failure of a financially important client in a limited liability regime. Table 1 summarizes participants' responses to the questions examined in this section.

In the first analysis, participants perceived high reputation firms to be more objective than low reputation firms (mean = 6.63 and mean = 5.39, respectively; $t = 2.119$, $p = 0.037$). High reputation firms were also considered to be more independent than low reputation firms during the engagement (mean = 5.95 and mean = 4.75, respectively; $t = 2.061$, $p = 0.043$). When asked whether participants perceived the auditors to be protecting their own interests by not disclosing the client's going concern issue, participants indicated that a significant difference did not exist between high and low reputation auditors (high reputation = 7.54 and low reputation = 6.83, respectively; $t = 1.243$, $p = 0.217$). Taken together, these results imply that jurors may perceive auditors as being concerned with protecting their financial interest in a client, but not at the expense of sacrificing their independence and objectivity during the engagement.

Brandon and Mueller (2006, p. 12) establish that perceived independence is a summary measure of perceptions of independence, objectivity, and motives to protect one's interest. A univariate analysis of variance (untabulated) finds that jurors' perceptions of an auditor's reputation for quality is statistically significant in explaining jurors' perceptions of independence (high reputation = 20.122 and

low reputation = 17.128, respectively; $F = 5.292$, $p = 0.024$). These results persist even after controlling for perceptions of the client's importance to the auditor ($F = 1.515$, $p = 0.222$) and the influence of the limited liability agreement in the audit ($F = 0.125$, $p = 0.724$). Thus, the comprehensive independence measure indicates that the auditor reputation manipulation was successful, in that high reputation firms are perceived as being more objective and independent than low reputation firms in the limited liability regime.

Perceptions of the auditor's reputation is found to significantly impact perceptions of client importance (high reputation = 8.63 and low reputation = 7.85; $t = 1.799$, $p = 0.076$). These results provide context to Brandon and Mueller's (2006) findings. The final assessment examines the proportion of blame that participants attributed to the auditor for the plaintiff's loss. Participants perceived no significant difference between high and low reputation firms with respect to their blameworthiness ($t = 0.094$, $p = 0.926$), the auditor's portion in causing the loss ($t = 0.184$, $p = 0.851$), the auditor's responsibility for the loss ($t = 0.420$, $p = 0.676$), and the auditor's propensity to not disclose the client's going-concern issue ($t = 0.113$, $p = 0.911$).

The preliminary analysis establishes that an auditor's reputation for quality significantly influences perceptions regarding an auditor's objectivity and independence during the engagement. However, the impact of an auditor who has a reputation for high quality may not be strong enough to deter jurors' concerns regarding an auditor's actual effort exerted in the presence of a limited liability agreement, or concerns regarding the auditor's desire to retain a financially important client. The following further examine these preliminary analyses.

TABLE 1
POST-EXPERIMENTAL QUESTIONS: JUROR'S PERCEPTIONS

| <u>Juror Perception of</u> | <u>Question</u> | <u>Lower Endpoint/ Upper EndPoint</u> | <u>Mean Response Auditor Reputation for Low Audit Quality</u> | <u>Mean Response Auditor Reputation for High Audit Quality</u> | <u>t-statistic</u> | <u>p-value</u> |
|--|--|---|--|---|---------------------------|-----------------------|
| Auditor Reputation for Quality | “What is Smith and Watkins, CPAs reputation for audit quality?” | Reputation For Low Audit Quality / Reputation For High Audit Quality | 4.40 41 | 8.90 41 | -5.960 | 0.000 |
| Limited Liability Agreement Importance | “How much of a factor did Smith & Watkins’ limited liability exposure agreement with Atlantis contribute to their decision as to whether they should consult an inventory specialist?” | Did Not Factor Into The Decision At All / Completely Factored Into The Decision | 6.95 41 | 7.17 41 | -0.318 | 0.751 |
| Hiring Specialist Decision | “How important was Smith & Watkins, CPAs’ decision regarding the employment of an inventory specialist to discovering the inventory error?” | Not at All Important / Extremely Important | 8.15 41 | 7.61 41 | 1.270 | 0.208 |
| Reputation Effect on Hiring Specialist | “How important was Smith & Watkins’ reputation for quality with respect to their decision to hire an inventory specialist?” | Not at All Important / Extremely Important | 7.55 41 | 8.05 41 | -8.96 | 0.373 |
| Client Importance | “How financially important was Atlantis (as a client) to the local office of Smith & Watkins?” | Not at All Important / Extremely Important | 7.85 41 | 8.63 41 | -1.799 | 0.076 |
| Objectivity | “To what extent do you believe that the local office of Smith & Watkins, CPAs, was objective during the audit of Atlantis?” | Not at All Objective / Completely Objective | 5.39 41 | 6.63 41 | -2.119 | 0.037 |

(continued on next page)

TABLE 1 (Continued)

| Juror Perception of | Question | Lower Endpoint/ Upper EndPoint | Mean Response Auditor Reputation for Low Audit Quality | Mean Response Auditor Reputation for High Audit Quality | t-statistic | p-value |
|----------------------------|---|---|---|--|--------------------|----------------|
| Independence | “To what extent do you believe that the local office of Smith & Watkins, CPAs was independent of Atlantis?” | Not at All Independent / Completely Independent | 4.75 40 | 5.95 41 | -2.061 | 0.043 |
| Motive | “To what degree do you believe that the auditors of Smith & Watkins were protecting their own interests by not warning stockholders and creditors of Atlantis’ negative business conditions?” | Not at All Protecting Own Interests / Completely Protecting Own Interests | 6.83 40 | 7.54 41 | -1.243 | 0.217 |
| Blame-worthiness | “To what extent do you believe that Smith & Watkins, CPAs, caused First Bank’s loss?” | No Blame / Complete Blame | 7.44 41 | 7.49 41 | -0.094 | 0.926 |
| Auditor as the Cause | “To what extent do you believe that Smith & Watkins, CPAs, caused First Bank’s loss?” | Did Not Cause / Completely Caused | 7.54 41 | 7.63 41 | -0.189 | 0.851 |
| Auditor Responsibility | “How responsible is Smith & Watkins, CPAs, for First Banks’s loss?” | Not at All Responsible / Completely Responsible | 7.59 41 | 7.80 41 | -0.420 | 0.676 |
| Plaintiff Responsibility | “To what extent do you believe that First Bank is responsible for its own loss?” | Not At All Responsible / Completely Responsible | 4.83 41 | 4.00 41 | 1.292 | 0.200 |
| Concession | “To what degree do you believe that the auditors of Smith & Watkins, CPAs gave in to Atlantis by not disclosing uncertainties about the future?” | Did Not Give In / Completely Gave in | 7.24 41 | 7.17 41 | 0.113 | 0.911 |
| Punitive Intent | “To what degree do you believe Smith & Watkins, CPAs, should be punished?” | No Punishment / Extremely Severe Punishment | 4.93 41 | 4.63 41 | 0.954 | 0.343 |

Responses for all scales range from 1 – 10, with the exception of punitive intent (measured on a scale of 0 – 6).

Test of Jurors' Auditor Liability Judgments

Hypothesis one examines the impact of an auditor's reputation on jurors' liability assessments subsequent to an audit failure involving a financially important client in the presence of a limited liability agreement. Table 2 (Panel A) presents the results of the univariate analysis of variance.

TABLE 2
THE IMPACT OF AUDITOR REPUTATION ON JURORS' ASSESSMENTS OF LIABILITY

| Panel A: Univariate Analysis of Variance | | | | | |
|---|-----------------------|-----------|--------------------|----------|----------------|
| <u>Source</u> | <u>Sum of Squares</u> | <u>df</u> | <u>Mean Square</u> | <u>F</u> | <u>p-value</u> |
| Model | 1.220 | 1 | 1.220 | 0.139 | 0.710 |
| Intercept | 10547.561 | 1 | 10547.561 | 1203.339 | 0.000 |
| Auditor Reputation | 1.220 | 1 | 1.220 | 0.139 | 0.710 |
| Error | 701.220 | 80 | 8.765 | | |
| Total | 11250.000 | 82 | | | |
| Corrected Error | 702.439 | 81 | | | |

| Panel B: Mean Liability Judgments | | | |
|--|---------------------|----------|-------------------------|
| <u>Variable of Interest</u> | <u>Manipulation</u> | <u>n</u> | <u>Mean (Std. Dev.)</u> |
| Auditor Reputation | Low | 41 | 11.2195 |
| | High | 41 | 11.4634 |

| Panel C: Chi-Square Analysis on Dichotomous Verdicts | | | | |
|---|-------|-------------------------|-------------------|--------------|
| | | Frequency Counts | | |
| | | Guilty Verdict | | Total |
| | | Guilty | Not Guilty | |
| Auditor Reputation | Low | 36 | 5 | 41 |
| | High | 34 | 7 | 41 |
| | Total | 70 | 12 | 82 |

Chi-square = 0.098, p-value = 0.755

Note: The liability assessment results from combining the dichotomous verdict (yes, no) with the seven point confidence-in-verdict scale (Likert). This produced a 14-point liability rating, anchored at 1 = not guilty and 14 = guilty.

Participants' perceptions of the impact of auditor reputation in explaining the mean negligence / liability ratings are in the expected direction, but are not statistically different (Table 2, Panel B; high reputation mean = 11.2195 and low reputation mean = 11.4634) (Table 2, Panel A; F = 0.139, p = 0.710). The nonsignificant auditor reputation manipulation (p = 0.710) differs from Krishnamurthy et al. (2006), whose archival research using public companies finds auditor reputation to be significant in terms of perceived quality. The results of the reputation coefficient are also consistent with Lennox (1999, 800), who suggests that auditor reputation does not explain the superior accuracy of large auditors (i.e. auditors with a reputation for high quality audits).

The univariate ANOVA was extended to understand whether the presence of a limited liability agreement—along with client importance, independence, the limited liability agreement, and the participant’s age—had a significant effect on the verdict. The results (untabulated) indicate that the auditor reputation variable remained nonsignificant ($F = 0.515$, $p = 0.475$), while only the client importance variable was marginally significant ($F = 2.868$, $p = 0.094$). The lack of a significant independence variable ($p = 0.390$) is consistent with Francis (2011), who suggests that independence alone does not deter audit failure. Finally, the nonsignificant coefficient for the limited liability variable ($p = 0.962$) establishes that the AICPA’s decision to allow limited liability agreements in the audit of nonpublic companies is not negatively perceived by jurors, irrespective of the firm’s reputation. All other potential covariates were nonsignificant ($p > 0.143$).

Table 2 (Panel C) reveals that no significant difference exists between the proportions of respondents who find the juror guilty of negligence in either condition (high reputation = 82.92 percent and low reputation = 87.80 percent; Chi-square = 0.098, p -value = 0.755). Collectively, the analysis indicates that hypothesis one is not supported. Jurors do not perceive auditor reputation as a form of social recognition to entice the auditor to remain objective during the audit. As such, the Social Cognitive Theory does not appear to describe juror’s behavior in the context of this research study.

Test of Punitive Damage Awards

Table 3 provides the statistical analysis for the test of the punitive damage awards. Hypothesis 2a examines the impact of auditor reputation on the likelihood that jurors may award punitive damages to the plaintiff by examining responses of the participants who deem the auditor to be guilty of negligence ($n = 67$). Consistent with Brandon and Mueller (2006, p. 12), a binary logistic regression model is employed in lieu of a Chi-square analysis in order to account for significant covariates. The binary logistic regression model that investigates this hypothesis is as follows:

$$\text{PunitiveAwarded} = \beta + \beta_1\text{AuditorReputation} + \beta_2\text{Classification} + \beta_3\text{Business Courses} + \beta_4\text{Limited Liability Agreement} + \beta_5\text{CurrentStockholder} \quad (1)$$

Correlation analysis identified the following covariates: student classification ($r = 0.353$, $p = 0.003$) and the number of business courses taken other than accounting ($r = 0.284$, $p = 0.020$). The current stockholder variable is not a significant covariate. However, the current stockholder variable is included in the model because Brandon and Mueller (2006, 12) suspected that current stockholders may be more likely to punish an auditor.

Table 3 (Panel A) includes the Chi-square statistic for the model ($\chi^2 = 9.019$, $p = 0.011$). The statistical analysis indicates that a nonsignificant positive relationship exists between auditor reputation and the assessment of punitive damages to the client ($p = 0.523$).

Hypothesis 2b examines the impact of an auditor’s reputation on the amount of punitive damages assessed to the client. Brandon and Mueller (2006, p. 14) note that high variability exists in the assignment of damage awards, which causes these awards to be positively skewed (the awards are positively skewed in the current research as well). Consistent with their research, this study evaluates punitive damage awards using their methodology. Two analyses were performed to test this hypothesis. The results are displayed in Table 3 (Panel B).

The first analysis selects cases in which the participant finds the auditor guilty of negligence, and includes all punitive damage awards, including \$0 damage awards. An independent samples t-test indicates that no significant difference exists ($t = 0.476$, $p = 0.636$) between the punitive damages awarded to low reputation firms (\$4,708,333) and high reputation firms (\$5,470,588).

The second analysis only examines participants who assigned punitive damages to the firms greater than \$0, and examines whether low reputation firms are assigned a higher amount of damages than high reputation firms. Once again, the auditor’s reputation does not impact jurors’ allocation of punitive damages (low reputation = \$7,062,500 and high reputation = \$8,851,142; $t = 0.885$, $p = 0.381$). A univariate analysis of variance test was performed in order to control for the covariate regarding whether

participants had previously served on a civil case. The covariate was significant in the model ($p = 0.006$), but the auditor reputation manipulation was not significant ($p = 0.188$).

TABLE 3
THE IMPACT OF AUDITOR REPUTATION ON JURORS' DAMAGE AWARDS

Panel A: Test of Punitive Award Incidence

Logistic Regression Model:

$$\text{PunitiveAwarded} = \beta + \beta_1\text{AuditorReputation} + \beta_2\text{Classification} + \beta_3\text{Business Courses} + \beta_4\text{Limited Liability Agreement} + \beta_5\text{CurrentStockholder}$$

Chi-Square Statistic = 9.019, p -value = 0.011

| <u>Parameter</u> | <u>Estimate</u> | <u>Wald X2</u> | <u>p-value</u> |
|----------------------|-----------------|----------------|----------------|
| Intercept | 0.065 | 0.032 | 0.857 |
| Auditor Reputation | | | 0.523 |
| Limited Liability | | | 0.103 |
| Classification (Fr.) | -1.569 | 3.324 | 0.068 |
| Classification (So.) | -1.674 | 6.529 | 0.011 |

Panel B: Tests of Various Measures of Punitive Award Amounts

| | <u>Descriptive Statistics</u> | | | <u>Mann-Whitney U Test</u> |
|---|------------------------------------|-------------------------------------|-------------------------------------|------------------------------|
| | <u>Auditor Reputation</u> | | | |
| | <u>Low Mean Median (Std. Dev.)</u> | <u>High Mean Median (Std. Dev.)</u> | <u>t-test t-statistic (p-value)</u> | <u>U-statistic (p-value)</u> |
| Punitive Award: Includes \$0 for Jurors Choosing Not to Award Punitive Damages (\$) | 4,708,333 (7,020,760) 36 | 5,470,588 (6,387,655) 34 | 0.476 (0.636) | |
| Punitive Award: Does Not Include \$0 for Jurors Choosing Not to Award Punitive Damages (\$) | 7,062,500 (7,593,350) 24 | 8,851,152 (5,985,697) 21 | 0.885 (0.381) | 179.00 ($p = 0.089$) |
| Log-Transformed Punitive Awards | 15.166 | 15.726 | 1.862 (0.039) | N/A |

Panel C: Test of Compensatory Award Amounts

| <u>Client Importance</u> | <u>n</u> | <u>Mean (Std. Dev.)</u> | <u>t-test t-statistic (p-value)</u> |
|--------------------------|----------|----------------------------|-------------------------------------|
| Low | 38 | 9,302,631 (6,376,201) | 1.505 (0.137) |
| High | 41 | 12,243,902 (10,615,508) | |

Note: The punitive award dependent variable in the logistic regression equation is coded as follows: 0 = no punitive damages rewarded, and 1 = punitive damages awarded.

However, the Mann-Whitney U-statistic (nonparametric test) finds the damages to be significantly different (Mann-Whitney $U = 179.00$, $p = 0.089$). The punitive damages were then log-transformed in order to account for the positively skewed nature of the punitive damages. A t-test confirmed the results of the nonparametric test; the results indicate that higher punitive damages are assessed to high reputation firms compared to low reputation firms ($t = 1.862$, $p = 0.069$).

The final analysis examines the degree to which participants believe that the defendant should be punished. This analysis is motivated by Brandon and Mueller (2006) and Kahneman et al. (1998), who find that jurors may experience difficulty translating auditor judgments into dollar amounts. Table 1 indicates that no significant difference exists regarding the degree to which jurors believe that high and low reputation auditors should be punished (high reputation = 4.63 and low reputation = 4.93, respectively; $t = 0.954$, $p = 0.343$). The number of law and political science classes was a significant covariate, but did not change the significance of the auditor reputation variable. Overall, H2a and H2b are not supported.

Test of Compensatory Damage Awards

A t-test confirmed that an auditor's reputation does not significantly impact juror's assignment of compensatory damage awards ($t = 1.505$, $p = 0.137$). These results persist in a univariate ANOVA analysis (untabulated), even after controlling for participants who currently hold stock ($F = 3.515$, $p = 0.035$). These results are reasonable, as compensatory damages are awarded in order to make the plaintiff whole, and an auditor's reputation should not factor into this decision.

CONCLUSION, LIMITATIONS, AND FUTURE RESEARCH

The fundamental observation to be extracted from this study is that an auditor's reputation for quality does not influence jurors' assignment of liability for negligence subsequent to an audit failure of an important client in a limited liability regime. Auditors with a reputation for high audit quality are no less likely to be guilty of negligence than auditors with a reputation for low audit quality. The auditor's reputation for quality does not impact jurors' assignment of punitive damages to the auditor or the degree of severity by which the auditor should be punished, regardless of the auditor's reputation for quality. Auditors who consider employing limited liability agreements, even international auditors, may find these results useful as they consider the possible reactions jurors may have in a limited liability agreement context. Finally, the nonsignificant difference in participant's assessments of liability and punitive damage awards to auditors with both low and high reputations for quality indicate that the social cognitive theory does not describe jurors' processing of auditor reputation in a limited liability regime.

As is common to experimental research, this research has limitations. First, jurors' responses to the experiment may have been affected by hindsight bias, despite efforts to minimize its effects, thus limiting the generalizability of the results to other jurors. A second limitation is that the amount of information received in the experiment is limited in order to accommodate time constraints of the participants.

A number of future research opportunities are needed to add to the body of knowledge. This study may be extended to examine the impact of auditor reputation in a limited liability context when the client is not financially important. Second, Hogarth (1991) suggests that cognitive research in the area of auditing successfully sheds light on several aspects of how auditors make decisions. Future research may directly examine whether Bandura's (1986) Social Cognitive Theory or other theories adequately explain jurors' intentions to assign liability, objectivity, and blameworthiness to an auditor based on the auditor's reputation prior to the engagement. Finally, archival research may investigate the propensity of international auditors to issue going concern opinions following a negligence verdict in the presence of a limitation of liability agreement.

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