

THE OBJECTIVITY OF ACCOUNTANTS' JUDGMENTS:

A REPLICATION AND EXTENSION

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The Objectivity of Accountants' Judgments: A Replication and Extension

ABSTRACT: This study examines accountants' objectivity in estimating the value of an account. Its purpose is to determine whether professional objectivity, in generating a fair and unbiased accounting estimate, will be influenced by a possible conflict of interest. Students, proxying as accountants, completed an experiment to test the impact of two factors that could create a conflict of interest: a client's legal position and fee structure of the engagement. We hypothesize that accountants will be influenced by their client's legal position when providing estimates, and will be even more influenced when there is the possibility of being paid a fee contingent on the estimate.

INTRODUCTION

Ponemon (1995) and Haynes et al. (1998) provide empirical evidence that suggests when client interests are explicitly made known to accountants, the accountants sometimes lose their objectivity and, in fact, act as client advocates. The current study utilizes the research instrument developed by Ponemon (1995) and expands on his work by addressing an important and little researched area – whether accounting services performed for contingent fees will induce an even greater loss of objectivity.

To further explain, a discussion of the scenario developed by Ponemon follows. Suppose a fire destroys a wholesaler's merchandise inventory and the company and its insurance carrier are in a legal dispute over the inventory loss. According to the wholesaler, the insurance carrier refuses to pay a fair value for the lost inventory so the wholesaler takes the insurance provider to court. Each side hires an accountant to provide an estimate of as to the fair value of the lost inventory. Intuitively, higher damages estimates are more favorable to the company in terms of insurance recovery while a lower estimate of the inventory loss would be more beneficial to the insurance carrier. Using this scenario, Ponemon found that contrary to the appearance of accountants taking an objective position, the accountants hired by the company made, on average, significantly larger inventory damage estimates than the other accountants.

Similarly, the accountants hired by the insurance carrier made, on average, significantly smaller damage estimates than the other accountants.

The validity of experimental research results in most areas of academia (e.g., medicine, psychology) is dependent on similar findings from multiple replications. However, replication is generally not a common practice in the accounting discipline. In accounting, replications of studies are rarely published because they are not thought to contribute substantially to the body of knowledge that has already been generated. When a replication does occur, it is usually due to a significant change within the field that could skew results, or may include an extension that would slightly alter the expected outcome. The present study replicates Ponemon's work and adds another independent variable, the presence of a contingency fee as explained below, to his original model.

While auditors cannot perform attestation services (e.g., audit or review) under a contingency fee arrangement, contingency fees can be used in many accounting services. Utilizing the Ponemon scenario as a basis, we manipulate the payment arrangement by comparing fixed fees to contingency fees. With the fixed fee contract, the accountant is paid a lump sum for representing (providing a damage estimate for) his or her client. With the contingent fee arrangement, the accountant's fee is determined by the outcome of the case. The accountant for the plaintiff (the wholesaler) would receive a larger fee if the settled damage estimate is high, and a lower fee if the settled damage estimate is low. The insurer's accountant would receive a percentage of cost savings; the more the insurance company saves (i.e., the less it has to pay the wholesaler), the greater the accountant's fee.

BACKGROUND AND HYPOTHESES

Objectivity

According to professional standards set by the American Institute of Certified Public Accountants (AICPA), objectivity is essential when performing accounting and auditing functions. In this context, objectivity is defined as a mental attitude that permits the individual accountant or auditor to fulfill

professional responsibilities without compromising judgment or ethical beliefs or yielding to the demands of others within and outside the organizations. The AICPA's Rules of Professional Conduct specifically address independence, integrity, and objectivity. Rule 101 states "A member in public practice shall be independent in the performance of professional services," and Rule 102 states "In performing any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

Research on accountant's objectivity has largely focused on the independence of auditors, but the results can largely be generalized to other accounting services. A key element in the literature on auditor's objectivity deals with the potential economic bonding between the auditor and the client. For example, Bazerman et al. (2002) suggests that motivational and cognitive biases can adversely affect auditors' judgments and impair independence. In a summarization of experiments on auditor independence, Church et al. (2015, 220) states that "much evidence suggests that auditors tend to evaluate client-provided information in a manner that suggest they are biased to 'approve' or 'confirm' the information. In addition, *auditors tend to evaluate evidence in a manner that supports client preferences when accounting standards are ambiguous*" (emphasis added).

Another aspect to be taken into consideration is that the impairment of objectivity may not always affect an accountant's work negatively. Taylor et al. (2003) emphasize that in order to understand the role of objectivity for auditors "it is critical to acknowledge that absolute objectivity is not possible in a judgment-based profession," and that it is unreasonable to expect auditors to have no concern in their client's interest at all. In fact, it is possible to perform auditing or accounting services reliably and appropriately without being fully independent, but sufficiently objective.

Contingency fees

Little research has been conducted on providing accounting services under a contingency fee arrangement, despite its growth in practice (Kroll 2013). A contingent fee is a fee arrangement in which

the total fee paid by a client is dependent on the attainment of a specific outcome (Pitkin 2015). For example, contingent fee arrangements are used by some accountants to “audit” overpayments to vendors. The accountant is hired by a company to examine its payment processes. If a duplicate payment is made, or if a discount is taken incorrectly—such as a 2% discount taken even if the payment is made beyond the normal 10 day window, then an overpayment occurs. The accountant earns a percentage of any refund received by the company from a vendor that was overpaid (e.g., the company receives, say, 85% of the overpayment, and 15% goes to the accountant). If no overpayments are returned to the company, the accountant receives no fee.

Proponents of contingency fee arrangements argue that the fee structure is beneficial to both the client (e.g., the company whose payables are being scrutinized) and the accountant. The company has nothing to lose. If no overpayments are found, nothing is paid to the accountant; if overpayments are discovered, then the company collects refunds it otherwise would not have received. The accountant benefits by having the potential to earn large fees, offset by resources spent on the service and possible losses when there are no findings (i.e., no overpayments).

Others view contingent fees critically and argue that they should be prohibited beyond their current constraints (e.g., performing an engagement on a contingency fee basis for an audit client creates a self-interest threat in that it puts the firm in a position of wanting the same outcome as the client, and thus contingent fees are not permissible for audits or any services provided to audit clients). Two primary arguments against the use of contingent fees for accounting services are that contingent fees create an incentive for the accountant to interpret standards in a manner that favors a certain client position, and the fee arrangement can result in auditors earning very large fees that might be out of proportion to the amount of time and expense expended by the auditor (AICPA 2015).

Despite the criticisms of contingent fees, they are allowed for some services per the AICPA’s Code of Professional Conduct which states that “A member in public practice shall not (1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or

the member's firm performs, (a) an audit or review of a financial statement; or (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or (c) an examination of prospective financial information; or (2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.”

The proposed study would be the first in the accounting literature, that we are aware of, to empirically test the impact of contingency fee arrangements on accountants’ behavior.

Hypotheses

The first hypothesis (H₁) of this study predicts similar results to those found by Ponemon; with a standard, fixed fee arrangement, damage estimates from the defendant’s accountant are most conservative (lowest), while estimates are most liberal (highest) from the plaintiff’s accountant. The estimate of the control group, representing the court (C), should fall in between. Notationally, H₁ can be stated as:

$$H_1: \hat{L}_D < \hat{L}_C < \hat{L}_P$$

where \hat{L} is the estimated loss from the fire, D is the defendant’s accountant (hired by the insurance company), C is the control group, and P is the plaintiff’s accountant (hired by the wholesaler that incurred damages in the fire).

The second hypothesis (H₂) predicts that contingent fees (CF) will result in more extreme estimates for the parties in litigation. The higher the potential is for greater payoff, the less objective the accountants’ estimates will be. Notationally, H₂ is shown as:

$$H_2: \hat{L}_D | CF < \hat{L}_D | FF < \hat{L}_C | FF < \hat{L}_P | FF < \hat{L}_P | CF$$

where \hat{L} , D, C, and P are previously defined, CF is contingent fee, and FF is fixed fee.

METHODOLOGY

Experimental Methods

A 2x2 between-subjects design is used to compare the responses of the participants under two manipulations: (1) whether the accountants are paid under a fixed fee or contingency fee arrangement, and (2) whether they are hired by the plaintiff (wholesaler) or defendant (insurance company).

Subjects completed an experimental task based on the computation of a physical inventory that was destroyed in a warehouse fire by using the gross profit method. The experimental materials included the description of the inventory, background on the damages incurred, and the nature of the litigation. The experimental materials can be found in appendix A.

The case scenario provided to the participants was a replication of Ponemon's original study, modified by changing the names and dates in the instrument, and adding an independent variable, fee structure. According to Ponemon, he chose the task for two primary reasons. First, the computation of damages is relatively easy to complete and does not require the participants to have any experience. Second, the historic gross profit percentages used in the computation of inventory varies during the relevant period of analysis, giving participants considerable flexibility in estimating damages. We chose to use Ponemon's study because it involves a task conducive testing fee structure (fixed or contingent) with little change to the instrument.

The following scenario was given to all participants to provide the background information of the experiment.

“On April 3, 2015 a fire destroyed the entire merchandise inventory on hand of Lenoir Wholesalers and Distributors, Inc. (LWD), a distributor of truck accessories and farm equipment. The company is a medium-sized business located in Charlotte, North Carolina with one primary warehouse location, and sells to truck and tractor dealerships throughout North America.

LWD's physical inventory, valued on an average cost basis, is fully insured by a policy based on the asset valuation or cost at the time of the fire. LWD did track quantities on-hand and kept perpetual records for its inventory assets, however, the computer system was not properly backed up and all inventory records were lost in the fire. Fortunately, LWD's controller was able to provide financial

information for computing damages using the gross profit method to value the inventory loss. The gross profit method takes the retail value of the inventory and deducts an average gross profit percentage to determine the inventory's approximate cost."

In addition, subjects were given the quantitative data shown in figure 1 for purposes of computing accounting damages.

[Insert Figure 1 here]

Each experimental instrument contained (1) the background description of the problem and quantitative data, (2) one of four experimental treatments (or a control group) concerning the legal position of the client who hired the accountant (plaintiff or defendant) and the manner in which fees are paid (fixed or contingent), (3) a brief schema that illustrated how to compute a missing inventory value using the gross profit method, and (4) a debriefing questionnaire used for manipulation checks and collecting demographic information.

Participants

Undergraduate and graduate student participants, proxying as practicing accountants, were selected based on their enrollment in accounting classes in which the experimental topic (inventory valuation) was similar to the material learned in class. Students were given an experiment dealing with the calculation and estimation of an organization's physical inventory loss using the gross profit method. In total, 222 subjects participated in this study with 119 individuals providing usable responses. Fifty-nine responses were eliminated due to incomplete data and 44 were eliminated because their responses were nonsensical based on the quantitative data given or the participants failed a manipulation check.

Treatments and Dependent Variable

Individuals were randomly assigned to one of four treatment groups or a control group. The control group was told that they represented a neutral third party (the court) and were paid a standard, fixed fee. The first and second treatment groups were told that they represented Lenoir Wholesalers and Distributors, Inc. (the plaintiff) who sued its insurance company for the fair value of insured inventory

assets. The third and fourth treatment groups were told that they represented the insurance company (the defendant) in determining the fair value of LWD's lost inventory. The first and third groups were told that they would be paid a standard, fixed fee while the second and fourth groups were told they would be paid a percentage of the amount of their estimate, based on the amount they saved their client (change this to be consistent with new instrument). The experimental treatments received by subjects were stated as follows.

Plaintiff with fixed fee: “*The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by LWD** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a standard, fixed fee.**”*

Plaintiff with contingent fee: “*The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by LWD** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a percentage of LWD's damage estimate [e.g., the higher the amount of the estimate, the higher the fee].**”*

Defendant with fixed fee: “*The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by the insurance company** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value court. For this service, you will be **paid a standard, fixed fee.**”*

Defendant with contingent fee: “*The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by the insurance company** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a percentage of the insurance company's savings estimate [e.g., the lower the amount of the estimate, the higher the fee].**”*

The remaining subjects were randomly assigned to a control group where experimental materials stated that the accountant is appointed by the court. The responses for individuals in this group should not be influenced by client advocacy considerations. All members of the control group received the following information.

***Control:** “The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **appointed by the court** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a standard, fixed fee.**”*

After reading the treatment, individuals were asked to compile the value of missing inventory, which served as the dependent variable of the study, using the quantitative data provided by employing the following formulation: $\text{Missing Inventory} = \text{Beginning Inventory} + \text{Purchases} - \text{Cost of Goods Sold}$, where $\text{Cost of Goods Sold} = [(1 - \text{Gross Profit Percent}) \times \text{Gross Sales}]$. After estimating LWD's inventory value, individuals were asked to express their confidence in their estimate using a 100 point continuous scale from “0” denoting no confidence to “100” denoting complete confidence.

The reliability of responses was determined by matching the estimated value of inventory to the range of possible values that could be obtained from the quantitative data provided, from \$3,008,356 to \$10,743,403, depending on the gross profit percentage used.

RESULTS

The evaluation of the dependent variable (inventory valuation) and descriptive statistics of inventory estimates are provided in table 1. According to H₁, the accountants are expected to provide a lower inventory value when they are hired by the defendant (insurance company) and a higher inventory value when they are hired by the plaintiff (LWD). According to H₂, the accountants are expected to provide an even lower inventory value when hired by the defendant (insurance company) and an even higher inventory value when they are hired by the plaintiff (LWD) when they are paid a contingency fee based on their performance. The inventory estimates provided by the accountants in the control group are used as a benchmark for objective estimation.

As shown in the ANOVA results in Table 1, panel A, the independent variable that captures differences in who hired the accountant (Client) is not statistically significant. While the data does not support H₁, the mean inventory valuation estimates (shown in Panel B of Table 1) are supported

directionally. The mean inventory value is higher for LWD (~\$6,294,000) than it is for the insurance company (~\$6,244,000) under both fee structures. However, contrary to what we expected, the mean inventory valuation for the control group (~\$5,747,000) does not lie between the mean inventory valuations of the plaintiff (LWD) and defendant (insurance company).

[Insert Table 1 here]

Contrary to our expectations in H₂, the independent variable Fee, which tests for difference between fixed and contingent fee structures, is also not significant. However, as illustrated in Figure 2, average inventory estimates for the plaintiff (LWD) were higher under a contingency fee arrangement (\$6,467,335) than under a fixed fee arrangement (\$6,154,771). In addition, average inventory estimates for the defendant (insurance company) were lower under the contingent fee condition (\$6,058,601) than under the fixed fee arrangement (\$6,453,701). Thus, while not supported statistically, the means follow the direction of H₂.

[Insert Figure 2 here]

We also tested the potential impact of the demographic information we collected (e.g., age, work experience, and student level [graduate or undergraduate]) on the participant's inventory estimates. Each item was run in the ANOVA model as a covariate but none were statistically significant.

DISCUSSION AND LIMITATIONS

Although the results of this study do not support the hypotheses we developed based on Ponemon's (1995) findings, there is a positive aspect involved. For the most part, our results find the participants to be objective. Several participants commented that they took fairness into consideration when choosing the gross profit percentage with which they calculated their inventory valuation. Considering all of the participants are accounting students rather than practicing accountants that likely have received ethics training and exposure to the AICPA's Code of Professional Conduct, the results could be viewed as an optimistic outlook for the future of the industry.

The major limitation of our study is that students may not have understood the experimental task used to compute the missing inventory. This is evidenced by the large variances in the estimates of the inventory valuation and the large number of nonsensical answers provided by the participants (and that were excluded from our data analysis).

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FIGURE 1

Quantitative data used in accounting computations

Gross Sales 01/11/15 to 04/03/15	\$55,250,341
Physical Inventory on 01/01/15	\$10,001,050
Freight-In 01/11/15 to 04/03/15	\$974,010
Merchandise purchases 01/11/15 to 04/03/15 (including 2,432,010 of goods in transit on 04/03/15, shipped f.o.b. shipping point from the vendor)	\$37,792,093
Purchase returns	\$1,889,032

Month	*Gross Profit %	Month	*Gross Profit %
04/2014	33%	10/2014	35%
05/2014	32%	11/2014	39%
06/2014	31%	12/2014	38%
07/2014	31%	01/2015	29%
08/2014	31%	02/2015	27%
09/2014	32%	03/2015	26%

Average gross profit for first quarter, 2014 = 35.2%
 Average gross profit for calendar year, 2014 = 34.0%
 Average gross profit for first quarter, 2015 = 27.3%
 Average gross profit for above 12 months = 32.0%
 Industry gross profit for calendar year 2014 = 25.0%

*The gross profit percentage equals the gross margin divided by total sales in a given monthly time period.

FIGURE 2

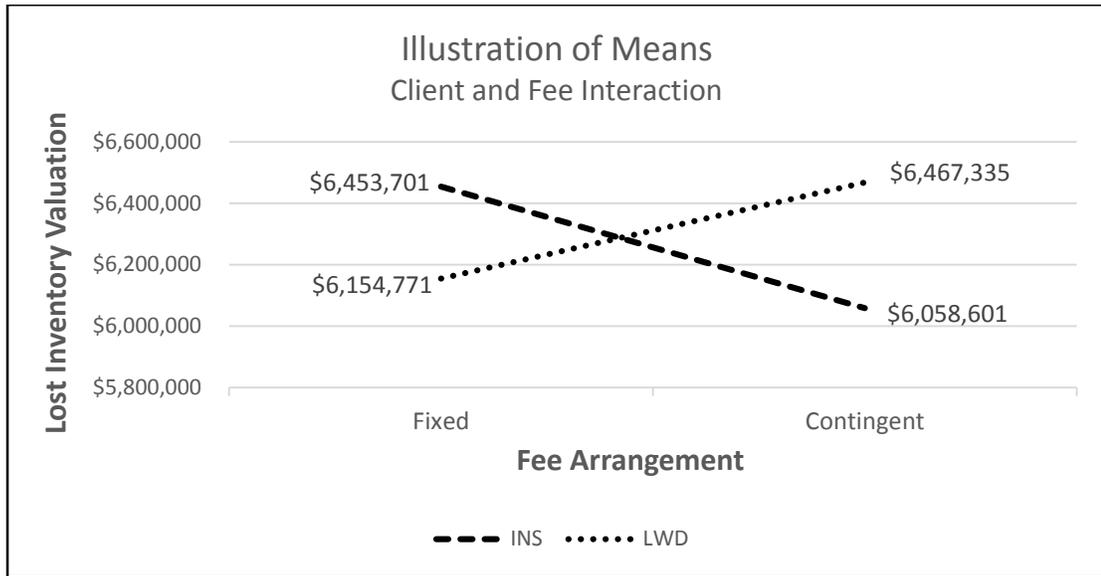


TABLE 1
Evaluation of Dependent Variable (Inventory Valuation)

Panel A: ANOVA Results

Independent Variables	Degrees of Freedom	F-ratio	p-value
Intercept	1	933.466	.000
Client	2	0.576	.564
Fee	1	0.009	.926
Client x Fee	1	0.645	.423
Error	114		
Total	119		

R²=.016

Panel B: Descriptive Statistics (in thousands)

CLIENT	FEE		Client (both fees types)
	Fixed	Contingent	
LWD	Mean \$6,155	Mean \$6,467	Mean \$6,294
	Std. Dev. \$2,177	Std. Dev. \$1,801	Std. Dev. \$2,002
	Minimum \$3,278	Minimum \$4,086	Minimum \$3,278
	Maximum \$10,223	Maximum \$9,860	Maximum \$10,223
INS	Mean \$6,454	Mean \$6,059	Mean \$6,244
	Std. Dev. \$2,248	Std. Dev. \$2,379	Std. Dev. \$2,302
	Minimum \$3,561	Minimum \$3,008	Minimum \$3,008
	Maximum \$10,362	Maximum \$10,223	Maximum \$10,362

CRT (control group)
Mean \$5,747
Std. Dev. \$1,941
Minimum \$3,561
Maximum \$10,413

APPENDIX A

The following contains the full experimental materials that were given to participants in this study.

Page 1

After reading the information on the next few pages, you will be asked to make a decision based on that information. You may want to have a calculator and scratch paper on hand to help you formulate your decision. You may go back to the preceding pages to help you recall information if you wish to view it again.

Page 2

On April 3, 2015 a fire destroyed the entire merchandise inventory on hand of Lenoir Wholesalers and Distributors, Inc. (LWD), a distributor of truck accessories and farm equipment. The company is a medium-sized business located in Charlotte, North Carolina with one primary warehouse location, and sells to truck and tractor dealerships throughout North America.

LWD's physical inventory, valued on an average cost basis, is fully insured by a policy based on the asset valuation or cost at the time of the fire. LWD did track quantities on-hand and kept perpetual records for its inventory assets, however, the computer system was not properly backed up and all inventory records were lost in the fire. Fortunately, LWD's controller was able to provide financial information for computing damages using the gross profit method to value the inventory loss. The gross profit method takes the retail value of the inventory and deducts an average gross profit percentage to determine the inventory's approximate cost.

The third page was randomized among the four possible experimental treatments or the control group (pages 3a-3e). One of the following was given to each participant.

Page 3a: The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by LWD** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a standard, fixed fee.**"

Page 3b: The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by LWD** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in

court. For this service, you will be **paid a percentage of LWD's damage estimate [e.g., the higher the amount of the estimate, the higher the fee]**.

Page 3c: The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by the insurance company** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value court. For this service, you will be **paid a standard, fixed fee**.

Page 3d: The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **hired by the insurance company** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a percentage of the insurance company's savings estimate [e.g., the lower the amount of the estimate, the higher the fee]**.

Page 3e: The insurance company and LWD management disagree about the settlement amount determined by the insurer's claims adjustment department. As a result, LWD sued the insurance company for breach of contract. You have been **appointed by the court** as an accounting expert to provide an estimated valuation of LWD's merchandise inventory lost in the fire on April 3, 2015, and to attest to this value in court. For this service, you will be **paid a standard, fixed fee**.

Page 4

The information provided by the controller (below) includes changes to LWD's gross profit based on normal seasonal variation, especially during the fall season, and the presence of significant competition from a large Korean firm who entered the U.S. and Canadian markets during the first quarter of 2015.

Gross Sales 01/11/15 to 04/03/15	\$55,250,341
Physical Inventory on 01/01/15	\$10,001,050
Freight-In 01/11/15 to 04/03/15	\$974,010
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Industry gross profit for calendar year 2014 = 25.0%

*The gross profit percentage equals the gross margin divided by total sales in a given monthly time period.

Compile the value of missing inventory by employing the following simple formulation:

Missing Inventory = Beginning Inventory + Purchases - Cost of Goods Sold,

where Cost of Goods Sold = [(1 - Gross Profit Percent) x Gross Sales].

Page 5

Express confidence in the accounting estimate you provided using a 100 point continuous scale from "0" denoting no confidence to "100" denoting complete confidence.

Page 6

Who hired you to develop an estimate of the inventory loss?

- LWD
- Insurance Company
- Court

How is the fee for your estimate determined?

- Contingent fee based on outcome
 - Standard, fixed fee
-

If participants selected that their fee was contingent on the outcome, they were asked one additional question.

Page 6a: How much was your decision influenced by the party paying your fee?

1=No influence, 7=Greatly influenced

Page 7

What factor(s) most influenced your estimate of the amount of inventory loss?

Page 8

What is your gender?

- Male
- Female

Are you enrolled as a graduate student or undergraduate student?

- Graduate student
- Undergraduate student

How many years of full-time work experience do you have?

How many years of full-time accounting or finance work experience do you have?